

GOLFSMITH INTERNATIONAL HOLDINGS INC

Form 10-Q

November 07, 2007

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

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

**For the quarterly period ended September 29, 2007**

**OR**

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

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

**Commission file number 000-52041**

**GOLFSMITH INTERNATIONAL HOLDINGS, INC.**

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

Delaware

(State or Other Jurisdiction of Incorporation or  
Organization)

16-1634847

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

11000 N. IH-35, Austin, Texas

(Address of Principal Executive Offices)

78753

(zip code)

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

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

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

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

Class of Common Stock

Outstanding at November 1, 2007

\$.001 par value

15,777,145 Shares

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

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**Table of Contents****PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****Golfsmith International Holdings, Inc.  
Consolidated Balance Sheets**

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

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

See accompanying notes to unaudited consolidated financial statements

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

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

See accompanying notes to unaudited consolidated financial statements

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

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

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

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

#### *Description of Business*

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

#### *Basis of Presentation*

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

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with US generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. As information in this report relates to interim financial information, certain footnote disclosures have been condensed or omitted. In the Company's opinion, the unaudited interim consolidated financial statements reflect all adjustments necessary for a fair presentation of the Company's financial position, results of operations and cash flows for the periods presented. This includes all normal and recurring adjustments, but does not include all of the information and footnotes required by generally accepted accounting principles ( GAAP ) for complete financial statements. These consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended December 30, 2006, included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission ( SEC ) on March 30, 2007. The results of operations for the three- and nine-month periods ended September 29, 2007 are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year.

The balance sheet at December 30, 2006 has been derived from the Company's audited consolidated financial statements at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, refer to the audited consolidated financial statements and notes thereto for the fiscal year ended December 30, 2006 included in the Company's Annual Report on Form 10-K filed with the SEC on March 30, 2007.

#### *Revenue Subject to Seasonal Variations*

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

#### *Fiscal Year*

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

#### *Recent Accounting Pronouncements*

In February 2007, Financial Accounting Standards Board ( FASB ) issued Statements of Financial Accounting Standards ( SFAS ) 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS 159 ). This statement expands the standards under SFAS 157, *Fair Value Measurement* ( SFAS 157 ), to provide entities the

one-time election (Fair Value Option or FVO) to measure financial instruments and certain other items at fair value. SFAS 159 also amends SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, to require the presentation of investments in available-for-sale securities and trading securities:

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

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

FAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. At the effective date, an entity may elect the fair value option for eligible items that exist at that date. The effect of the re-measurement is reported as a cumulative-effect adjustment to opening retained earnings. The Company is currently evaluating the effect that the adoption of SFAS 159 will have on its financial position and results of operations. In September 2006, the FASB issued SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value under GAAP and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the effect that the adoption of SFAS 157 will have on its financial position and results of operations. In June 2006, the FASB issued FASB Interpretation ( FIN ) 48, *Accounting for Uncertainty in Income Taxes* ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS 109, *Accounting for Income Taxes*, ( SFAS 109 ). FIN 48 defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements and seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. The Company is subject to the provisions of FIN 48 as of January 1, 2007. The Company believes that its income tax filing positions and deductions will be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position. Therefore, no material reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

**2. Intangible Assets**

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

|                                            | <b>September<br/>29,<br/>2007</b> | <b>December 30,<br/>2006</b> |
|--------------------------------------------|-----------------------------------|------------------------------|
| Customer database gross carrying amount    | \$ 3,399,205                      | \$ 3,399,205                 |
| Customer database accumulated amortization | (1,888,447)                       | (1,605,180)                  |
| Customer database net carrying amount      | \$ 1,510,758                      | \$ 1,794,025                 |

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

**3. Debt***First Amendment to the Amended and Restated Credit Agreement*

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



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

The Credit Facility contains customary affirmative covenants regarding, among other things, the delivery of financial and other information to the lenders, maintenance of records, compliance with law, maintenance of property and insurance and conduct of business. The Credit Facility also contains certain customary negative covenants that limit the ability of the Credit Parties to, among other things, create liens, make investments, enter into transactions with affiliates, incur debt, acquire or dispose of assets, including merging with another entity, enter into sale-leaseback transactions and make certain restricted payments. The foregoing restrictions are subject to certain customary exceptions for facilities of this type. The Credit Facility includes events of default (and related remedies, including acceleration of the loans made thereunder) usual for a facility of this type, including payment default, covenant default (including breaches of the covenants described above), cross-default to other indebtedness, material inaccuracy of representations and warranties, bankruptcy and involuntary proceedings, change of control, and judgment default. Many of the defaults are subject to certain materiality thresholds and grace periods usual for a facility of this type. Available amounts under the Credit Facility are based on a borrowing base. The borrowing base is limited to (i) 85% of the net amount of eligible receivables, as defined in the Credit Facility, plus (ii) the lesser of (x) 70% of the value of eligible inventory or (y) up to 90% of the net orderly liquidation value of eligible inventory, plus (iii) the lesser of (x) \$17,500,000 or (y) 70% of the fair market value of eligible real estate, and minus (iv) \$3.5 million, which is an availability block used to calculate the borrowing base. The availability block may be increased to \$5.0 million in the event the Lender chooses to syndicate the loan. At September 29, 2007, the Company had \$42.5 million outstanding under the Credit Facility leaving \$44.0 million in borrowing availability. At December 30, 2006, the Company had \$41.5 million outstanding under the Credit Facility (as described below in this Note 3) leaving \$21.0 million in borrowing availability.

### ***Amended and Restated Credit Agreement***

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

### **4. Long-Lived Assets**

The Company accounts for the impairment or disposal of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment of Long-Lived Assets* (SFAS 144), which requires long-lived assets, such as property and equipment, to be evaluated for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. An impairment loss is recognized when estimated future undiscounted cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset, if any, are less than the carrying value of the asset. When an impairment loss is recognized, the carrying amount of the asset is reduced to its estimated fair value in the period in which the determination is made. There were no impairment losses for the three- and nine-month periods ended September 29, 2007 or September 30, 2006, respectively.

### **5. Accrued Expenses and Other Current Liabilities**

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



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

**6. Comprehensive Income**

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

**7. Earnings Per Share**

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

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

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

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

#### **8. Stock-Based Compensation**

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



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

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

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

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

**9. Guarantees**

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

The Company has no operations nor any assets or liabilities other than its investment in its wholly-owned subsidiary Golfsmith. Domestic subsidiaries of Golfsmith comprise all of Golfsmith's assets, liabilities and operations. There are no restrictions on the transfer of funds between the Company, Golfsmith and any of Golfsmith's domestic subsidiaries. The Company offers warranties to its customers depending on the specific product and terms of the goods purchased. A typical warranty program requires that the Company replace defective products within a specified time period from the date of sale. The Company records warranty costs as they are incurred, historically such costs have not been material. During the three- and nine-month periods ended September 29, 2007 and September 30, 2006, respectively, no material amounts have been accrued or paid relating to product warranties.

**10. Commitments and Contingencies***Lease Commitments*

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

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

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

***State Income Taxes***

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

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

***Legal Proceedings***

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

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

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

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

*Forward-looking statements are not guarantees of performance. These statements are based on our management's beliefs and assumptions, which in turn are based in part on currently available information and in part on management's estimates and projections of future events and conditions. Important assumptions relating to the forward-looking statements include, among others, assumptions regarding demand for our products, the introduction of new product offerings, store opening costs, our ability to lease new sites on a timely basis, expected pricing levels, the timing and cost of planned capital expenditures, competitive conditions and general economic conditions. These assumptions could prove inaccurate. Forward-looking statements also involve risks and uncertainties, which could cause actual results that differ materially from those contained in any forward-looking statement. Many of these factors are beyond our ability to control or predict. Such factors include, but are not limited to the Risk Factors set forth in Item 1A. Risk Factors in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2007.*

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

#### **Overview**

We believe that we are the nation's largest specialty retailer of golf and tennis equipment, apparel and accessories based on sales. We were founded in 1967 as a golf club-making company offering custom-made clubs, club-making 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 past three decades we have continued to expand our product offerings, open retail stores and add to our catalog titles. In 1997, we launched our Internet site to further expand our direct-to-consumer business. In October 2002, Atlantic Equity Partners III, L.P., an investment fund managed by First Atlantic Capital, Ltd. acquired us from our original founders, Carl, Barbara and Franklin Paul. On June 20, 2006, we completed an initial public offering of our common stock.

Since 2002 we have expanded our retail presence in the United States by opening 50 new stores including 12 new stores in fiscal 2007 as of September 29, 2007. In addition, we intend to open a new store which, at 60,000 square feet is larger than our previous store formats, in the fourth quarter of 2007. We continue to explore opportunities to open additional stores in existing and new geographic markets, but we do not provide any assurances about the rate at which we will open new stores in the future, and our historical record in this regard is no indication of our current or future strategy. We currently anticipate reducing our 2008 square footage growth as compared to 2007.

A major part of our strategy has been the direct-to-consumer channel, and we plan to continue our efforts to grow that channel. In addition, we have acquired and developed a number of proprietary brands, and we plan to continue our efforts to grow our proprietary brands.

As of November 1, 2007, we operate 73 retail stores in 18 states and 24 markets, which include 13 of the top 15 golf markets. We operate as an integrated multi-channel retailer, offering our customers the convenience of shopping in our retail locations across the nation and through our direct-to-consumer channel, consisting of our Internet site, [www.golfsmith.com](http://www.golfsmith.com), and our comprehensive catalogs.

**Fiscal Year**

Our fiscal year ends on the Saturday closest to December 31 and generally consists of 52 weeks, although occasionally our fiscal year will consist of 53 weeks. Each quarter of each fiscal year generally consists of 13 weeks. The three-month periods ended September 29, 2007 and September 30, 2006, respectively, each consisted of 13 weeks. The nine-month periods ended September 29, 2007 and September 30, 2006, respectively, each consisted of 39 weeks.

**Table of Contents****Industry Trends**

The golf retail industry is highly fragmented among mass merchants, off-course specialty retailers such as ourselves, internet merchants, warehouse-type merchants and on-course pro shops. The off-course specialty golf retail industry is becoming increasingly competitive as competitors enter our geographical markets and as we enter geographical markets that are new to us against existing competition. The Dallas, Texas and Atlanta, Georgia markets, specifically, have experienced significant increased competition. We expect the increase in competition in the golf and tennis retail industry to continue, which could negatively impact revenues, gross profit and net income. In addition to increased competition, our higher profit margin club component business has been in decline for the last several years and may continue to decline, thus negatively impacting our gross profit and operating income. We believe this decline is due to waning interest by consumers in building their own clubs, the rise of the now more accessible pre-owned club market and the increase of brand name closeouts from the top manufacturers resulting from shorter product life cycles. Sales of our products are affected by increases and decreases in golfer participation rates. According to the National Golf Foundation ( NGF ), the number of rounds played has had minimal increases over the past four years, although the number has declined 0.2% over the last nine months. A variety of factors affect recreational activities including the state of the nation's economy, weather conditions and consumer confidence. NGF believes the dollar value spend in the golf retail market will remain stable or grow slightly over the next year. Therefore, we expect that any growth for a golf and tennis specialty retail company will result primarily from market share gains. To increase our market share, we believe that we will need to continue to expand our retail presence in existing and new geographic markets. In addition, we also must continue to compete effectively in the direct-to-consumer channel and expand our proprietary brands.

**Revenues**

*Revenue channels.* We generate substantially all of our revenues from sales of golf and tennis products in our retail stores, through our direct-to-consumer distribution channels and from other sources including international distributors. The following table provides information about the breakdown of our revenues for the periods indicated:

|                                         | Three Months Ended    |     |                       |     | Nine Months Ended  |     |                    |     |
|-----------------------------------------|-----------------------|-----|-----------------------|-----|--------------------|-----|--------------------|-----|
|                                         | September 29,<br>2007 |     | September 30,<br>2006 |     | September 29, 2007 |     | September 30, 2006 |     |
|                                         | (in<br>thousands)     |     | (in<br>thousands)     |     | (in<br>thousands)  |     | (in<br>thousands)  |     |
| Stores                                  | \$84,755              | 79% | \$71,629              | 76% | \$239,158          | 77% | \$209,640          | 74% |
| Direct-to-consumer                      | 19,793                | 19% | 20,698                | 22% | 63,771             | 21% | 67,859             | 24% |
| International<br>distributors and other | 1,979                 | 2%  | 1,653                 | 2%  | 6,260              | 2%  | 5,430              | 2%  |

Our revenue growth continues to be driven by the expansion of our store base while our direct-to-consumer revenue channel continues to decline. The decline in our direct-to-consumer channel is largely due to the decline of the club-component business.

*Store revenues.* Changes in revenues generated from our stores are driven primarily by the number of stores in operation and changes in comparable store sales. We consider sales by a new store to be comparable commencing in the fourteenth month after the store was opened or acquired. We consider sales by a relocated store to be comparable if the relocated store is expected to serve a comparable customer base and there is not more than a 30-day period during which neither the original store nor the relocated store is closed for business. We consider sales by retail stores with modified layouts to be comparable. We consider sales by stores that are closed to be comparable in the period leading up to closure if they meet the qualifications of a comparable store and do not meet the qualifications to be classified as discontinued operations under Statement of Financial Accounting Standards ( SFAS ) No. 144, *Accounting for the Impairment of Long-Lived Assets* ( SFAS 144 ).

*Branded compared to proprietary products.* The majority of our sales are generated from premier-branded golf and tennis equipment, apparel and accessories from leading manufacturers and are sold through all of our channels. In addition, we sell proprietary-branded equipment, components, apparel and accessories under a variety of trademarked

brand names. Sales of our proprietary-branded products constituted approximately 13.4% and 13.3% of our net revenues for the three- and nine-month periods ended September 29, 2007, respectively, and approximately 12.8% and 13.2% of our net revenues for the three- and nine-month periods ended September 30, 2006, respectively. Our proprietary-branded products are sold through all of our channels and generally generate higher gross profit margins than premier-branded products.

*Seasonality.* Our business is seasonal, and our sales leading up to and during the warm weather golf season and the

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December holiday gift-giving season have historically contributed a higher percentage of our annual net revenues and annual net operating income than other periods in our fiscal year. The months encompassing these seasons are responsible for the majority of our annual net revenues and substantially all of our annual operating income.

### **Cost of Goods Sold**

We capitalize inbound freight and vendor discounts into inventory upon receipt of the inventory. These costs and discounts increase and decrease, respectively, the value of inventory recorded on our consolidated balance sheets. These costs and discounts are then subsequently reflected in cost of products sold upon the sale of that inventory. Because some retailers exclude these costs from cost of products sold and instead include them in a line item such as selling, general and administrative expenses, our gross profit may not be comparable to those of other retailers. Salary and facility expenses, such as depreciation and amortization, associated with our distribution and fulfillment center in Austin, Texas are included in cost of products sold. Income received from our vendors through our co-operative advertising program that does not pertain to incremental direct advertising costs is recorded as a reduction to cost of products sold when the related merchandise is sold.

### **Operating Expenses**

Our selling, general and administrative expenses consist of all expenses associated with general operations for our stores and general operations for corporate and international expenses. This includes salary expenses, occupancy expenses, including rent and common area maintenance, advertising expenses and direct expenses, such as supplies for all retail and corporate facilities. A portion of our occupancy expenses are offset through our subleases to GolfTEC Learning Centers. Additionally, income received through our co-operative advertising program for reimbursement of incremental direct advertising costs is treated as a reduction to our selling, general and administrative expenses. Selling, general and administrative expenses in the three- and nine-month periods ended September 30, 2006 also included the fees and other expenses we paid for services rendered to us pursuant to a management consulting agreement between us and First Atlantic Capital, Ltd. Under this agreement, we paid First Atlantic Capital, Ltd. fees and related expenses totaling \$0.3 million for the nine months ended September 30, 2006. This contract was terminated in June 2006, and thus no amounts were paid under this agreement during the nine months ended September 29, 2007. Upon termination of our management agreement in June 2006, we paid a \$3.0 million termination fee to First Atlantic Capital, Ltd., which was expensed at such time and included in selling, general, and administrative expenses. We have agreed to reimburse First Atlantic Capital, Ltd. for expenses incurred in connection with meetings between representatives of First Atlantic Capital, Ltd. and us in connection with Atlantic Equity Partners III, L.P.'s investment in us, and business matters that First Atlantic Capital, Ltd. attends to on our behalf for so long as Atlantic Equity Partners III, L.P. holds at least 20% of our outstanding shares of our common stock.

### **Store pre-opening expenses**

Our store pre-opening expenses consist of costs associated with the opening of a new store and include costs of hiring and training personnel, supplies and certain occupancy and miscellaneous costs. Rent expense recorded after possession of the leased property but prior to the opening of a new retail store is recorded as store pre-opening expenses.

### **Interest expense**

Our interest expense for the three- and nine-month periods ended September 29, 2007, consists of costs related to our First Amendment to the Amended and Restated Credit Agreement (the "First Amendment") and the Amended and Restated Credit Agreement, (jointly, the "Credit Facility"). Our interest expense for the three- and nine-month periods ended September 30, 2006 consists of costs related to our Credit Facility, and our Senior Secured Notes and Old Senior Secured Credit Facility.

### **Interest income**

Our interest income consists of amounts earned from our cash balances held in short-term money market accounts.

### **Other income**

Other income consists primarily of exchange rate variances and other transactions outside of our normal course of business.

### **Other expense**

Other expense consists primarily of exchange rate variances.

**Income taxes**

Our income taxes consist of federal, state and foreign taxes, based on the effective rate for the fiscal year.

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**Table of Contents****Results of Operations**

The following table sets forth selected consolidated statements of operations data for each of the periods indicated:

|                                     | <b>Three Months Ended<br/>(unaudited)</b> |                          |               |               | <b>Nine Months Ended<br/>(unaudited)</b> |                          |               |               |
|-------------------------------------|-------------------------------------------|--------------------------|---------------|---------------|------------------------------------------|--------------------------|---------------|---------------|
|                                     | <b>September<br/>29,</b>                  | <b>September<br/>30,</b> |               |               | <b>September<br/>29,</b>                 | <b>September<br/>30,</b> |               |               |
|                                     | <b>2007</b>                               | <b>2006</b>              | <b>\$</b>     | <b>%</b>      | <b>2007</b>                              | <b>2006</b>              | <b>\$</b>     | <b>%</b>      |
|                                     | <b>(in thousands)</b>                     |                          | <b>Change</b> | <b>Change</b> | <b>(in thousands)</b>                    |                          | <b>Change</b> | <b>Change</b> |
| Net revenues                        | \$ 106,527                                | \$ 93,980                | \$ 12,547     | 13.4%         | \$ 309,188                               | \$ 282,929               | \$ 26,259     | 9.3%          |
| Cost of products sold               | 68,706                                    | 61,609                   | 7,097         | 11.5%         | 200,841                                  | 183,054                  | 17,787        | 9.7%          |
| Gross profit                        | \$ 37,821                                 | \$ 32,371                | 5,450         | 16.8%         | \$ 108,347                               | \$ 99,875                | 8,472         | 8.5%          |
| Selling, general and administrative | 32,605                                    | 28,384                   | 4,221         | 14.9%         | 97,570                                   | 86,249                   | 11,321        | 13.1%         |
| Store pre-opening expenses          | 271                                       | 197                      | 74            | 37.6%         | 2,050                                    | 1,420                    | 630           | 44.4%         |
| Operating income                    | \$ 4,945                                  | \$ 3,790                 | \$ 1,155      | 30.4%         | \$ 8,727                                 | \$ 12,206                | \$ (3,479)    | -28.5%        |

**As a  
percentage of  
net revenues**

|                                     |       |       |       |       |
|-------------------------------------|-------|-------|-------|-------|
| Cost of products sold               | 64.5% | 65.6% | 65.0% | 64.7% |
| Gross profit                        | 35.5% | 34.4% | 35.0% | 35.3% |
| Selling, general and administrative | 30.6% | 30.2% | 31.6% | 30.5% |
| Store pre-opening expenses          | 0.3%  | 0.2%  | 0.7%  | 0.5%  |
| Operating income                    | 4.6%  | 4.0%  | 2.8%  | 4.3%  |

**Comparison of Three- and Nine-month Periods Ended September 29, 2007 and September 30, 2006, respectively**

***Net Revenues***

| <b>Three Months Ended<br/>(unaudited)</b> |                          | <b>Nine Months Ended<br/>(unaudited)</b> |                          |
|-------------------------------------------|--------------------------|------------------------------------------|--------------------------|
| <b>September<br/>29,</b>                  | <b>September<br/>30,</b> | <b>September<br/>29,</b>                 | <b>September<br/>30,</b> |

| <i>(dollars in thousands)</i> | <b>2007</b> | <b>2006</b> | <b>Change</b> | <b>%<br/>Change</b> | <b>2007</b> | <b>2006</b> | <b>\$ Change</b> | <b>%<br/>Change</b> |
|-------------------------------|-------------|-------------|---------------|---------------------|-------------|-------------|------------------|---------------------|
| Net revenues                  | \$ 106,527  | \$ 93,980   | \$ 12,547     | 13.4%               | \$ 309,188  | \$ 282,929  | \$ 26,259        | 9.3%                |
| Comparable stores             | 69,079      | 69,250      | (171)         | -0.2%               | 196,526     | 203,576     | (7,050)          | -3.5%               |
| Non-comparable stores         | 15,677      | 2,380       | 13,297        | 558.7%              | 42,632      | 6,064       | 36,568           | 603.0%              |

**Three Month Comparison**

Net revenues increased by 13.4% for the three months ended September 29, 2007 compared with the same period in the prior year. The increase was due to a \$13.1 million increase from our store revenues partially offset by a decrease of \$0.9 million in our direct to-consumer revenue channel. The increase in our store revenues was due to an increase in our non-comparable store revenues resulting from the opening of 15 new stores subsequent to September 30, 2006. Five stores entered our comparable store base during the three-month period ended September 29, 2007. Our comparable store revenues declined by 0.2% for the three-month period ended September 29, 2007, compared to the three-month period ended September 30, 2006. Comparable store revenues continue to be negatively impacted by increased competition in select geographic markets as well as declines in our retail club component business. In addition to these competitive and product mix factors, golf rounds played in the United States, a leading indicator of golf participation tracked by the NGF, increased 1.8% in the three-month period ended September 29, 2007 compared to the three-month period ended September 30, 2006. One store will move into our comparable store revenue base in the fourth quarter of fiscal 2007.

**Nine Month Comparison**

Net revenues increased by 9.3% for the nine months ended September 29, 2007 compared with the same period in the prior year. The increase was due to a \$29.5 million increase from our store revenue channel offset by a decrease of \$4.1 million in our direct-to-consumer revenue channel. The increase in our store revenue channel was due to an increase in our non-comparable store revenues resulting from the opening of the majority of our new stores in the first half of fiscal 2007. In comparison, our new store openings in the prior fiscal year were spread more evenly over the entire fiscal 2006.

Seven stores entered our comparable store base during the nine-month period ended September 29, 2007. Our comparable store revenues declined by 3.5% for the nine-month period ended September 29, 2007, compared to the nine-month period ended September 30, 2006. Comparable store revenues continue to be negatively impacted by increased competition in

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select geographic markets as well as declines in our retail club component business. In addition to these competitive and product mix factors, golf rounds played in the United States, as reported by the NGF, has declined 0.2% during the nine-month period ended September 29, 2007 compared to the nine-month period ended September 30, 2006. One store will move into our comparable store revenue base in the fourth quarter of fiscal 2007.

*Gross Profit*

|                                              | <b>Three Months Ended<br/>(unaudited)</b> |                          |               |                     | <b>Nine Months Ended<br/>(unaudited)</b> |                          |                  |                     |
|----------------------------------------------|-------------------------------------------|--------------------------|---------------|---------------------|------------------------------------------|--------------------------|------------------|---------------------|
|                                              | <b>September<br/>29,</b>                  | <b>September<br/>30,</b> |               |                     | <b>September<br/>29,</b>                 | <b>September<br/>30,</b> |                  |                     |
| <i>(dollars in thousands)</i>                | <b>2007</b>                               | <b>2006</b>              | <b>Change</b> | <b>%<br/>Change</b> | <b>2007</b>                              | <b>2006</b>              | <b>\$ Change</b> | <b>%<br/>Change</b> |
| Cost of products sold                        | \$ 68,706                                 | \$ 61,609                | \$ 7,097      | 11.5%               | \$ 200,841                               | \$ 183,054               | \$ 17,787        | 9.7%                |
| As a percentage of net revenues              | 64.5%                                     | 65.6%                    |               |                     | 65.0%                                    | 64.7%                    |                  |                     |
| Gross profit                                 | \$ 37,821                                 | \$ 32,371                | \$ 5,450      | 16.8%               | \$ 108,347                               | \$ 99,875                | \$ 8,472         | 8.5%                |
| Gross profit as a percentage of net revenues | 35.5%                                     | 34.4%                    | 1.1%          |                     | 35.0%                                    | 35.3%                    | -0.3%            |                     |

*Three Month Comparison*

Increased revenues led to higher gross profits for the three-month period ended September 29, 2007 compared to the three-month period ended September 30, 2006. In addition, our gross margin increased to 35.5% in the three-month period ended September 29, 2007 from 34.4% in the three-month period ended September 30, 2006. The increase in gross margins was primarily due to us being less promotional in our sales efforts and increasing our co-operative vendor programs. In addition, growth in the sales of our higher margin proprietary-branded items outpaced our total revenue growth. These increases were partially offset by higher sales of lower margin products, such as clubs and electronic accessories, and an increase in our estimate for inventory shrinkage expense compared to the same period in the prior fiscal year.

*Nine Month Comparison*

Increased revenues led to higher gross profits for the nine-month period ended September 29, 2007 compared to the nine-month period ended September 30, 2006. However, gross margins decreased primarily due to higher sales of lower margin products such as golf clubs and electronic accessories and is also a reflection of increased competition. In addition, we recorded an increase in inventory valuation expense, which was primarily related to an increase in our estimate for inventory shrinkage expense over the same period in the prior year. These factors causing declines in gross profit were partially offset by increases in our co-operative vendor programs and also shipping profits, which was related to a reduction in promotional shipping terms offered to our customers.

*Selling, General and Administrative*

|                                              | <b>Three Months Ended<br/>(unaudited)</b> |                          |               |                     | <b>Nine Months Ended<br/>(unaudited)</b> |                          |                  |                     |
|----------------------------------------------|-------------------------------------------|--------------------------|---------------|---------------------|------------------------------------------|--------------------------|------------------|---------------------|
|                                              | <b>September<br/>29,</b>                  | <b>September<br/>30,</b> |               |                     | <b>September<br/>29,</b>                 | <b>September<br/>30,</b> |                  |                     |
| <i>(dollars in thousands)</i>                | <b>2007</b>                               | <b>2006</b>              | <b>Change</b> | <b>%<br/>Change</b> | <b>2007</b>                              | <b>2006</b>              | <b>\$ Change</b> | <b>%<br/>Change</b> |
| Selling, general and administrative expenses | \$ 32,605                                 | \$ 28,384                | \$ 4,221      | 14.9%               | \$ 97,570                                | \$ 86,249                | \$ 11,321        | 13.1%               |
|                                              | 30.6%                                     | 30.2%                    |               |                     | 31.6%                                    | 30.5%                    |                  |                     |

As a percentage of net  
revenues

Three Month Comparison

Selling, general and administrative expenses increased by 14.9% for the three-month period ended September 29, 2007 compared with the same period in the prior year. The increase in selling, general and administrative expenses was primarily due to increases in occupancy and personnel costs related to the opening of 15 stores subsequent to September 30, 2006. The increase in selling, general and administrative expenses was also partially due to increases in corporate support costs as we have built our infrastructure to manage the growth of our company. These increases were partially offset by a reduction in advertising costs for the three-month period ending September 29, 2007 compared to the same period in the prior year.

Nine Month Comparison

Selling, general and administrative expenses increased by 13.1% for the nine-month period ended September 29, 2007 compared with the same period in the prior year. The increase in selling, general and administrative expenses was primarily due to increases in occupancy and personnel costs related to the opening of 15 stores subsequent to September 30, 2006. The increase in selling, general and administrative expenses was also partially due to increases in corporate support costs as we have built our infrastructure to manage the growth of our company and an increase in our advertising costs as we have entered markets that are new to us. The increase in our advertising expenses was also a result of our continuing efforts to

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build brand awareness in select highly competitive geographic markets. These increases were offset by \$3.3 million of management fees recorded during the first two quarters of fiscal year 2006 which included a \$3.0 million fee related to the early termination of our management consulting agreement with First Atlantic Capital Ltd.

*Store Pre-Opening Expenses*

|                                 | <b>Three Months Ended<br/>(unaudited)</b> |                          |               |                     | <b>Nine Months Ended<br/>(unaudited)</b> |                          |                      |                     |
|---------------------------------|-------------------------------------------|--------------------------|---------------|---------------------|------------------------------------------|--------------------------|----------------------|---------------------|
|                                 | <b>September<br/>29,</b>                  | <b>September<br/>30,</b> |               |                     | <b>September<br/>29,</b>                 | <b>September<br/>30,</b> |                      |                     |
| <i>(dollars in thousands)</i>   | <b>2007</b>                               | <b>2006</b>              | <b>Change</b> | <b>%<br/>Change</b> | <b>2007</b>                              | <b>2006</b>              | <b>\$<br/>Change</b> | <b>%<br/>Change</b> |
| Store pre-opening expenses      | \$ 271                                    | \$ 197                   | \$74          | 37.6%               | \$ 2,050                                 | \$ 1,420                 | \$630                | 44.4%               |
| As a percentage of net revenues | 0.3%                                      | 0.2%                     |               |                     | 0.7%                                     | 0.5%                     |                      |                     |

*Three Month Comparison*

During the three-month period ended September 29, 2007, we incurred \$0.3 million of expenses related to the opening of one new retail location. During the three months ended September 30, 2006, we incurred \$0.2 million of expenses related to the opening of one new retail location.

*Nine Month Comparison*

During the nine-month period ended September 29, 2007, we incurred \$2.1 million of expenses related to the opening of twelve new retail locations. During the nine-month period ended September 30, 2006, we incurred \$1.4 million of expenses related to the opening of seven new retail locations.

*Interest expense.* Interest expense did not significantly change in the three-month period ended September 29, 2007 compared to the three-month period ended September 30, 2006. For the nine months ended September 29, 2007, interest expense decrease by \$3.9 million to \$2.7 million from \$6.6 million in the nine-months ended September 30, 2006. The decrease in interest expense for the nine-month comparison is due to the retirement of our Senior Secured Notes in June 2006.

*Interest income.* Interest income decreased \$0.3 million in the three months ended September 29, 2007 as compared to the three months ended September 30, 2006. For the nine-month period ended September 29, 2007, interest income decreased \$0.4 million as compared to the nine-month period ended September 30, 2006. The decrease in interest income for both the three- and nine-month comparisons is due to the escrow utilized for the retirement of our Senior Secured Notes in fiscal 2006.

*Other income.* Other income did not significantly change in the three-month period ended September 29, 2007 compared to the three-month period ended September 30, 2006. For the nine months ended September 29, 2007, other income decreased by \$1.2 million from the nine months ended September 30, 2006. The decrease was primarily due to the recording of \$1.0 million in derivative income recorded in the second quarter of fiscal 2006 due to the change in the fair value of an option granted to the underwriters of our initial public offering, as well as the recording of \$0.3 million, in the first quarter of fiscal 2006, for declared settlement income resulting from the Visa Check / MasterMoney Antitrust Litigation class action lawsuit, in which we were a claimant. These decreases were partially offset by a \$0.2 million gain recorded in June 2007, for the sale of rights to certain intellectual property.

*Other expense.* Other expense did not change significantly in the three- or nine-month periods ended September 29, 2007 compared to the three- or nine-month periods ended September 30, 2006, respectively.

*Extinguishment of debt.* Upon the closing of the initial public offering on June 20, 2006, we remitted payment of \$94.4 million to the trustee to retire our Senior Secured Notes. We recorded a loss of \$12.8 million on the extinguishment of this debt as reported in our statement of operations. This loss was the result of: (1) the contractually obligated amounts to retire the debt being larger than the accreted value of the Senior Secured Notes on our balance sheet at the time of settlement of \$86.2 million, including accrued interest; (2) the write-off of debt issuance costs related to the Senior Secured Notes of \$4.2 million; and (3) transaction fees associated with the retirement of the

Senior Secured Notes of \$0.3 million.

*Income taxes.* Income taxes, which relate primarily to foreign and state income taxes, increased by \$0.3 million in both the three- and nine-month periods ended September 29, 2007 compared to the three- and nine-month periods ended September 30, 2006, respectively.

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### **Liquidity and Capital Resources**

We had cash and cash equivalents of \$3.2 and \$1.8 million as of September 29, 2007 and December 30, 2006, respectively. At September 29, 2007 we had outstanding debt obligations of \$42.5 million and \$44.0 million in borrowing availability under our Credit Facility. At December 30, 2006, we had outstanding debt obligations of \$41.5 million and \$21.0 million in borrowing availability under our Amended and Restated Credit Agreement. Based on our current business plan, we believe our existing cash balances and cash generated from operations, and borrowing availability under our Credit Facility, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for the near term. If our estimates of revenues, expenses or capital or liquidity requirements change or are inaccurate or if cash generated from operations is insufficient to satisfy our liquidity requirements, we may seek to sell additional equity or arrange additional debt financing or be required to reduce our planned capital expenditures or operating expenses. Cash reductions could include outflows related to new store openings, store retrofittings or advertising expenses. In addition, in the future, we may seek to sell additional equity or arrange debt financing to fund our general business operations and objectives, including the cost to open new stores, acquisitions, mergers and infrastructure investments. If cash from operations and from our Credit Facility is not sufficient to fund our expected growth, we cannot assure you that we will be able to obtain additional financing in sufficient amounts and on acceptable terms. You should read the information set forth under **Risk Factors** as set forth in Item 1A. Risk Factors, in our Annual Report on Form 10-K filed with the Securities and Exchange Commission ( SEC ) on March 30, 2007.

### **Cash Flows**

#### *Operating activities*

Net cash provided by operating activities was \$12.4 million in the nine months ended September 29, 2007, compared to net cash used in operating activities of \$0.1 million in the nine months ended September 30, 2006. Cash provided by operating activities was generated primarily due to an increase of \$6.5 million related to the timing of payments for general working capital activities and a decrease in cash used for the purchase of inventory of \$3.5 million, net of accounts payable. In addition, the cash benefits associated with deferred rent increases contributed \$2.5 million to the net cash provided by operating activities.

#### *Investing activities*

Net cash used in investing activities was \$12.2 million for the nine months ended September 29, 2007, compared to net cash used in investing activities of \$12.1 million for the nine months ended September 30, 2006. The cash used in investing activities was largely driven by the purchase of capital assets to outfit 12 new stores in the nine-month period ended, September 29, 2007.

#### *Financing activities*

Net cash provided by financing activities was \$1.1 million for the nine months ended September 29, 2007, compared to net cash provided by financing activities of \$9.6 million for the nine months ended September 30, 2006. Net cash provided by financing activities for the nine months ended September 29, 2007, was comprised primarily of proceeds from our line of credit which were used to fund purchases of inventory and purchase capital assets for the opening of stores in the first three quarters of the 2007 fiscal year. Net cash provided by financing activities for the nine months ended September 30, 2006 was comprised of proceeds from the IPO, net of settled transaction costs, of \$61.2 million along with proceeds from our Amended and Restated Credit Agreement and Old Senior Secured Credit Facility of \$130.8 million. These cash inflows were partially offset by cash used of \$94.4 million to retire the Senior Secured Notes, and cash used of \$87.5 million to repay existing indebtedness under our Old Senior Secured Credit Facility and our Amended and Restated Credit Agreement. For additional information on the Old Senior Secured Credit Facility and the Senior Secured Notes, please refer to our Annual Report filed on Form 10-K with the Securities and Exchange Commission ( SEC ) on March 30, 2007.

### ***Indebtedness***

#### *First Amendment to the Amended and Restated Credit Agreement*

On September 26, 2007, the existing Amended and Restated Credit Agreement of Golfsmith International Holdings, Inc. ( Holdings ), as guarantor, and its subsidiaries (the Amended and Restated Credit Agreement ), was amended by entering into the First Amendment to the Amended and Restated Credit Agreement by and among Golfsmith

International, L.P., Golfsmith NU, L.L.C., and Golfsmith USA, L.L.C., as borrowers (the Borrowers ), Holdings and the subsidiaries of Holdings identified therein as Credit Parties (the Credit Parties ), General Electric Capital Corporation ( the Lender ), as Administrative Agent, Swing Line Lender and Letter of Credit Issuer, GE Capital Markets, Inc., as Sole Lead Arranger and Bookrunner, and the financial institutions from time to time parties thereto (the First Amendment together with the Amended and Restated Credit Agreement constitute the ( Credit Facility ). The Credit Facility consists of a \$90.0 million



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asset-based revolving credit facility (the **Revolver** ), including a \$5.0 million letter of credit subfacility and a \$10.0 million swing line subfacility. On an ongoing basis, certain loans incurred under the Credit Facility will be used for the working capital and general corporate purposes of the Borrowers and their subsidiaries (the **Loans** ). Loans incurred under the Credit Facility bear interest in accordance with a graduated pricing matrix based on the average excess availability under the Revolver for the previous quarter. Borrowings under the Credit Facility are jointly and severally guaranteed by the Credit Parties, and are secured by a security interest granted in favor of the Administrative Agent, for itself and for the benefit of the lenders, in all of the personal and owned real property of the Credit Parties, including a lien on all of the equity securities of the Borrowers and each of Borrower's subsidiaries. The Credit Facility expires on June 16, 2011.

The Credit Facility contains customary affirmative covenants regarding, among other things, the delivery of financial and other information to the lenders, maintenance of records, compliance with law, maintenance of property and insurance and conduct of business. The Credit Facility also contains certain customary negative covenants that limit the ability of the Credit Parties to, among other things, create liens, make investments, enter into transactions with affiliates, incur debt, acquire or dispose of assets, including merging with another entity, enter into sale-leaseback transactions and make certain restricted payments. The foregoing restrictions are subject to certain customary exceptions for facilities of this type. The Credit Facility includes events of default (and related remedies, including acceleration of the loans made thereunder) usual for a facility of this type, including payment default, covenant default (including breaches of the covenants described above), cross-default to other indebtedness, material inaccuracy of representations and warranties, bankruptcy and involuntary proceedings, change of control, and judgment default. Many of the defaults are subject to certain materiality thresholds and grace periods usual for a facility of this type. Available amounts under the Credit Facility are based on a borrowing base. The borrowing base is limited to (i) 85% of the net amount of eligible receivables, as defined in the Credit Facility, plus (ii) the lesser of (x) 70% of the value of eligible inventory or (y) up to 90% of the net orderly liquidation value of eligible inventory, plus (iii) the lesser of (x) \$17,500,000 or (y) 70% of the fair market value of eligible real estate, and minus (iv) \$3.5 million, which is an availability block used to calculate the borrowing base. The availability block may be increased to \$5.0 million in the event the Lender chooses to syndicate the loan. At September 29, 2007, the Company had \$42.5 million outstanding under the Credit Facility leaving \$44.0 million in borrowing availability. At December 30, 2006, the Company had \$41.5 million outstanding under the Credit Facility (as described in Note 3 of the footnotes) leaving \$21.0 million in borrowing availability.

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

**Contractual Obligations**

The following table of our material contractual obligations as of September 29, 2007, summarizes the aggregate effect that these obligations are expected to have on our cash flows in the periods indicated:

| Contractual Obligations             | Total             | Payments Due by Period |                  |                  |                  |
|-------------------------------------|-------------------|------------------------|------------------|------------------|------------------|
|                                     |                   | Less than              | 1 -3             | 4 - 5            | After 5          |
|                                     |                   | 1 year                 | Years            | Years            | Years            |
| (in thousands)                      |                   |                        |                  |                  |                  |
| Operating leases                    | \$ 173,155        | \$ 23,020              | \$ 43,622        | \$ 42,915        | \$ 63,598        |
| Purchase obligations <sup>(1)</sup> | 9,982             | 9,578                  | 404              |                  |                  |
| <b>Total</b>                        | <b>\$ 183,137</b> | <b>\$ 32,598</b>       | <b>\$ 44,026</b> | <b>\$ 42,915</b> | <b>\$ 63,598</b> |

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

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### **Capital Expenditures**

We expect to spend approximately \$3.0 million on capital expenditures to update existing stores and to open a new store in a store format that is larger than that of our other stores.

### **Off-Balance Sheet Arrangements**

As of September 29, 2007, we did not have any off-balance sheet arrangements, as defined by the rules and regulations of the SEC.

### **Critical Accounting Policies and Estimates**

Our significant accounting policies are more fully described in Note 1 of our audited consolidated financial statements in our Annual Report on Form 10-K filed with the SEC on March 30, 2007. Certain of our accounting policies are particularly important to the portrayal of our financial position and results of operations. In applying these critical accounting policies, our management uses its judgment to determine the appropriate assumptions to be used in making certain estimates. Those estimates are based on our historical experience, the terms of existing contracts, our observance of trends in the industry, information provided by our customers and information available from other outside sources, as appropriate. These estimates are subject to an inherent degree of uncertainty.

#### *Revenue Recognition.*

We recognize revenue from retail sales at the time the customer takes possession of the merchandise and purchases are paid for, primarily with either cash or by credit card. We recognize revenues from catalog and Internet sales upon shipment of merchandise and any service related revenue as the services are performed.

We recognize revenue from the sale of gift cards and issuance of returns credits when (1) the cards or credits are redeemed by the customer, or (2) the likelihood of the cards or credits being redeemed by the customer is remote (breakage) and we determine that there is no legal obligation to remit the value of the unredeemed cards or credits to the relevant jurisdiction. Estimated breakage is calculated and recognized as revenue over a 48-month period following the card or credit issuance, in amounts based on the historical redemption patterns of the used cards or credits. The difference in total estimated breakage, if any, is recognized as a component of revenue at the end of the 48 months following the issuance of the card or credit, at which time we deem the likelihood of any further redemptions to be remote, and provided that such amounts are not required to be remitted to the relevant jurisdictions. Breakage income is included in net revenue in the consolidated statements of operations.

For all merchandise sales, we reserve for sales returns in the period of sale using estimates based on our historical experience.

#### *Inventory Valuation*

Merchandise inventories are carried at the lower of cost or market. Cost is the sum of expenditures, both direct and indirect, incurred to bring inventory to its existing condition and location. Cost is determined using the weighted-average method. We write down inventory value for damaged, obsolete, excess and slow-moving inventory and for inventory shrinkage due to anticipated book-to-physical adjustments. Based on our historical results, using various methods of disposition, we estimate the price at which we expect to sell this inventory to determine the potential loss if those items are later sold below cost. The carrying value for inventories that are not expected to be sold at or above costs are then written down. A significant adjustment in these estimates or in actual sales may have a material adverse impact on our net income.

Write-downs for inventory shrinkage are based on management's estimates and recorded as a percentage of net revenues on a monthly basis at rates commensurate with the most recent physical inventory results within the respective distribution channel. Inventory shrinkage expense recorded in the statements of operations was 1.0% and 0.7% of net revenues for the three-month periods ended September 29, 2007 and September 30, 2006, respectively. Inventory shrinkage expense recorded in the statements of operations was 1.1% and 0.7% of net revenues for the nine-month periods ended September 29, 2007 and September 30, 2006, respectively. Inventory shrinkage expense recorded is a result of physical inventory counts made during these respective periods and write-down amounts recorded for periods outside of the physical inventory count dates.

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

We account for the impairment or disposal of long-lived assets in accordance with SFAS No. 144, which requires long-lived assets, such as property and equipment, to be evaluated for impairment whenever events or changes in

circumstances indicate the carrying value of an asset may not be recoverable. An impairment loss is recognized when estimated future undiscounted cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the

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asset, if any, are less than the carrying value of the asset. When an impairment loss is recognized, the carrying amount of the asset is reduced to its estimated fair value. There were no material write-offs of assets in any of the three or nine-month periods ended September 29, 2007 or September 30, 2006, respectively.

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

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

No impairment of goodwill or identifiable intangible assets was recorded in any of the three- or nine-month periods ended September 29, 2007 or September 30, 2006, respectively.

### ***Product Return Reserves***

We reserve for product returns based on estimates of future sales returns related to our current period sales. We analyze historical returns, current economic trends, current returns policies and changes in customer acceptance of our products when evaluating the adequacy of the reserve for sales returns. Any significant increase in merchandise returns that exceeds our estimates would adversely affect our operating results and financial condition. In addition, we may be subject to risks associated with defective products, including product liability. Our current and future products may contain defects, which could subject us to higher defective product returns, product liability claims and product recalls. Because our allowances are based on historical return rates, we cannot assure you that the introduction of new merchandise in our stores or catalogs, the opening of new stores, the introduction of new catalogs, increased sales over the Internet, changes in the merchandise mix or other factors will not cause actual returns to exceed return allowances. We book reserves as a percentage of net revenues on a monthly basis at rates commensurate with the latest historical twelve-month trends within the distribution channel in which the sales occur. Net returns reserve expenses recorded in the statement of operations were 3.3% and 3.8% of net revenues for the three-month periods ended September 29, 2007 and September 30, 2006, respectively. Net returns reserve expenses recorded in the statement of operations were 3.5% and 3.6% of net revenues for the nine-month periods ended September 29, 2007 and September 30, 2006, respectively. We routinely compare actual experience to current reserves and make any necessary adjustments.

### ***Store Closure Costs***

When we decide to close a store we comply with the accounting guidance provided by SFAS No. 146, *Accounting For Costs Associated With Exit or Disposal Activities* (SFAS 146). Under SFAS 146, we estimate the future cashflows generated and expenses expected to be incurred through the store's shutdown date. In the event that the expected expenses exceed the estimated future cashflows of the store, we recognize an expense to reflect that amount directly related to the shutdown of the store. These charges require us to make judgments about exit costs to be incurred for employee severance, lease terminations, inventory to be disposed of, and other liabilities. The ability to obtain

agreements with lessors, to terminate leases or to assign leases to third parties can materially affect the accuracy of these estimates.

We did not close any stores during the three- or nine-month periods ended September 29, 2007 and September 30, 2006,

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respectively. We currently plan to close three stores in fiscal 2008 due to the expiration of the lease terms. We do not forecast the necessity to record any expense amounts under SFAS No. 146 for any of the three planned store closures in fiscal 2008 because the estimated future cashflows exceed the expected expenses incurred through the stores shutdown dates.

### *Operating Leases*

We enter into operating leases for our retail locations. Other than our Austin campus retail location, which we own, store lease agreements often include rent holidays, rent escalation clauses and contingent rent provisions for percentage of sales in excess of specified levels. Most of our lease agreements include renewal periods at our option. We recognize rent holiday periods and scheduled rent increases on a straight-line basis over the lease term beginning with the date we take possession of the leased space. We record tenant improvement allowances and rent holidays as deferred rent liabilities on our consolidated balance sheets and amortize the deferred rent over the term of the lease to rent expense on our consolidated statements of operations. We record rent liabilities on our consolidated balance sheets for contingent percentage of sales lease provisions when we determine that it is probable that the specified levels will be reached during the fiscal year. We record direct costs incurred to effect a lease in other long-term assets and amortize these costs on a straight-line basis over the lease term beginning with the date we take possession of the leased space.

### *Deferred Tax Assets*

A deferred income tax asset or liability is established for the expected future consequences resulting from temporary differences in the financial reporting and tax bases of assets and liabilities. As of September 29, 2007, and December 30, 2006, we recorded full valuation allowances against accumulated net deferred tax assets of \$7.4 million due to the uncertainties regarding the realization of deferred tax assets. If we generate taxable income in future periods or if the facts and circumstances on which our estimates and assumptions are based were to change, thereby impacting the likelihood of realizing the deferred tax assets, judgment would have to be applied in determining the amount of valuation allowance no longer required. Reversal of all or a part of this valuation allowance could have a significant positive impact on our net income in the period that it becomes more likely than not that certain of our deferred tax assets will be realized.

### *Stock Compensation*

We follow the guidance set by SFAS 123 (revised 2004), *Share-Based Payment*, ( SFAS 123(R) ) to record stock compensation expense. As such, we are required to calculate and record the appropriate amount of compensation expense over the estimated service period in our consolidated statement of operations based on the fair value of the related awards at the time of issuance or modification. We use the Black-Scholes fair value pricing model to estimate the fair value of stock option and stock grant awards granted under SFAS 123(R). The Black-Scholes model incorporates various and highly subjective assumptions including expected volatility, expected term and interest rates during the service period. The calculation of expected volatility is based on a combination of our historical volatility and the historical volatility for a comparable industry peer group over periods of time equivalent to the expected life of each stock option grant. Due to our relatively short trading history in the public equity markets, we believe this basis provides a more reasonable measurement of volatility in order to calculate the fair value of each stock award. The expected term is calculated based on the average of the remaining vesting term, the remaining contractual life and the expected life of each award. We base the estimate of risk-free rate on the U.S. Treasury yield curve in effect at the time of grant or modification. We have never paid cash dividends and do not currently intend to pay cash dividends, and thus have assumed a 0% dividend yield. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 ( SAB 107 ), relating to SFAS 123(R). We have applied the provisions of SAB 107 in our adoption of SFAS 123(R). Results for prior periods have not been restated.

In addition, as part of the requirements of SFAS 123(R), we are required to estimate potential forfeitures of stock grants and adjust compensation cost recorded accordingly. The estimate of forfeitures will be adjusted over the requisite service period to the extent that actual forfeitures differ, or are expected to differ, from such estimates. Changes in estimated forfeitures will be recognized through a cumulative catch-up adjustment in the period of change and will also impact the amount of stock compensation expense to be recognized in future periods.

### **Recent Accounting Pronouncements**

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

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

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

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

In September 2006, the Financial Accounting Standards Board ( FASB ) issued SFAS 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the effect that the adoption of SFAS 157 will have on our financial position and results of operations.

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

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

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

*Interest Rate Risk*

The interest payable on our Credit Facility is based on variable interest rates and is therefore affected by changes in market interest rates. As of September 29, 2007, if the maximum available amount under the credit facility of \$90.0 million less the availability block of \$3.5 million had been drawn and the variable interest rate applicable to our variable rate debt had increased by 10 percentage points, our interest expense would have increased by \$8.7 million on an annual basis, thereby materially affecting our results from operations and cash flows. As our debt balances consist strictly of the Credit Facility discussed herein, we were not party to or at risk for additional liability due to interest rate sensitivity associated with any interest rate swap or other interest related derivative instruments during the three- and nine-month periods ended September 29, 2007. We regularly review interest rate exposure on our outstanding borrowings in an effort to evaluate the risk of interest rate fluctuations.

*Foreign Currency Risks*

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

We operate a fulfillment center in Toronto, Canada and a sales, marketing and fulfillment center near London, England, which expose us to market risk associated with foreign currency exchange rate fluctuations. At this time, we do not manage the risk through the use of derivative instruments. A 10% adverse change in foreign currency exchange rates would not have a significant impact on our results of operations or financial position. Additionally, we were not a party to any derivative instruments during the three- and nine-month periods ended September 29, 2007, respectively.

**Item 4. Controls and Procedures**

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

*Internal Control over Financial Reporting.* During the three months ended September 29, 2007, there have been no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II: OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are involved in various legal proceedings arising in the ordinary course of conducting business. We are not aware of any such lawsuits, the ultimate outcome of which, individually or in the aggregate, are likely to have a material adverse impact on our financial results or consolidated financial statements.

**Item 1A. Risk Factors**

There have been no material changes in our risk factors with respect to our quarter ended September 29, 2007 from those disclosed in our annual report on Form 10-K filed with the SEC on March 30, 2007.

**Item 6. Exhibits**

- 10.01 First Amendment to Amended and Restated Credit Agreement, dated September 26, 2007, entered into by and among, Golfsmith International L.P., Golfsmith NU, L.L.C., Golfsmith USA, L.L.C. the other Credit Parties party hereto, and General Electric Capital Corporation (incorporated by reference to the Company's Form 8-K, filed on October 2, 2007).
- 10.02 Syndication letter for the First Amendment to the Amended and Restated Credit Agreement, entered into by and among, Golfsmith International L.P., Golfsmith NU, L.L.C., Golfsmith USA, L.L.C. the other Credit Parties party hereto, and General Electric Capital Corporation (incorporated by reference to the Company's Form 8-K, filed on October 2, 2007).
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of James D. Thompson.
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Virginia Bunte.
- 32.1 Certification of James D. Thompson Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Virginia Bunte Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

GOLFSMITH INTERNATIONAL HOLDINGS, INC.

By: /s/ James D. Thompson  
James D. Thompson  
Chief Executive Officer, President and Director  
(Principal Executive Officer and Authorized Signatory)  
Date: November 7, 2007

By: /s/ Virginia Bunte  
Virginia Bunte  
Chief Financial Officer  
(Principal Accounting Officer and Authorized Signatory)  
Date: November 7, 2007