

1 800 CONTACTS INC  
Form 10-K  
March 18, 2004

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

**FORM 10-K**

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

For the fiscal year ended January 3, 2004 or

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

For the transition period from to .

Commission file number: 0-23633

**1-800 CONTACTS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or  
organization)

**87-0571643**

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

**66 E. Wadsworth Park Drive, Draper, UT**

(Address of principal executive offices)

**84020**

(Zip Code)

Registrant's telephone number, including area code: **(801) 924-9800**

**Securities registered pursuant to Section 12(b) of the Act: Not applicable**

**Securities registered pursuant to Section 12(g) of the Act:**

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**Common Stock, par value \$.01 per share**  
(Title of Class)

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

Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes  No

The aggregate market value of voting common equity held by non-affiliates of the registrant as of June 28, 2003 at a closing sale price of \$25.00 as reported by the Nasdaq National Market ( Nasdaq ) was approximately \$173.0 million. Shares held by each officer and director and by each person who owns or may be deemed to own 10% or more of the outstanding Common Stock have been excluded since such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 3, 2004, the Registrant had 13,114,777 shares of Common Stock, par value \$0.01 per share, outstanding.

**Documents Incorporated by Reference**

Portions of the Registrant's Proxy Statement to be used in connection with the solicitation of proxies for the Annual Meeting of Stockholders to be held on May 21, 2004 (the Proxy Statement ) are incorporated by reference in Part III of this Annual Report on Form 10-K (the Form 10-K ).

**1-800 CONTACTS, INC.**

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**PART I**

**Item 1. Business.**

**Overview**

1-800 CONTACTS, INC. (the Company) was incorporated under the laws of the State of Utah in February 1995 and was reincorporated under the laws of the State of Delaware in February 1998 in conjunction with its initial public offering of common stock. The Company's principal executive office is located at 66 E. Wadsworth Park Drive, Draper, Utah 84020, and its telephone number is (801) 924-9800. The Company maintains various websites on the Internet, including, [www.1800contacts.com](http://www.1800contacts.com), [www.contacts.com](http://www.contacts.com) and [www.contactlenses.com](http://www.contactlenses.com). The Company provides on these websites, free of charge, periodic and current reports as soon as is reasonably practicable after such material is filed with or furnished to the SEC.

The Company is the leading direct marketer of replacement contact lenses. The Company recently announced that it had shipped its ten millionth order to more than 5 million customers since inception. Through its easy-to-remember, toll-free telephone number, 1-800 CONTACTS (1-800-266-8228), and through its Internet addresses, the Company sells all of the popular brands of contact lenses, including those manufactured by Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision. The Company's high volume, cost-efficient operations, supported by its proprietary management information systems, enable it to offer consumers an attractive alternative for obtaining replacement contact lenses in terms of convenience, price, speed of delivery and customer service. As a result of its extensive inventory of more than 35,000 SKUs, the Company generally ships approximately 95% of its orders within one business day of receipt and verification of prescriptions.

The Company's Internet sales channel continued to grow in fiscal 2003 and enhances the Company's ability to cost effectively serve its customers. The Company's Internet sales accounted for approximately half of its total revenue during 2003. Its online presence enables the Company to operate more efficiently by substantially reducing the payroll and long distance costs associated with telephone orders. This increased efficiency allows the Company to offer Internet customers free shipping in addition to other services such as e-mail shipping confirmation, online order tracking and e-mail correspondence.

The Company markets its products through a national advertising campaign that aims to increase recognition of the 1-800 CONTACTS brand name, increase traffic on its website, add new customers, continue to build strong customer loyalty and maximize repeat purchases. As compared to other direct marketers of replacement contact lenses, the Company believes that its toll-free telephone number and Internet addresses afford it a significant competitive advantage in generating consumer awareness and repeat business. The Company spent approximately \$20.2 million on advertising in fiscal 2003 and has invested more than \$130 million in its national advertising campaign over the last several years. The Company's experience has been that increases in advertising expenditures have a direct impact on the growth of net sales.

On July 24, 2002, the Company completed the acquisition of certain net assets and the majority of the business operations of IGEL, a developer and manufacturer of contact lenses based in Singapore. The acquisition was effected through a wholly owned subsidiary of the Company, IGEL Acquisition Co. Pte Ltd (subsequently renamed ClearLab Pte Ltd). Subsequent to year-end, ClearLab Pte Ltd has been renamed ClearLab International. ClearLab International will be the principal marketing organization for the Company's international wholesale manufacturing business, focusing on the marketing of contact lens products to major retailers and distributors, as well as providing contract manufacturing

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capacity for other contact lens manufacturers. ClearLab International manufactures a wide range of frequent replacement spherical and toric lenses and is focused on developing new lens materials.

On February 24, 2004, the Company acquired VisionTec, a developer and manufacturer of daily contact lenses based in the United Kingdom. VisionTec has developed a method for low cost, high quality production of daily

disposable contact lenses using a unique proprietary material. VisionTec has subsequently been renamed ClearLab UK Ltd ( ClearLab UK ). The business will operate as a manufacturing affiliate of ClearLab International. The Company has recently completed the testing of its manufacturing capabilities for ClearLab UK's daily products and is currently expanding its production capabilities. The Company will increase its product offerings to the international markets in fiscal 2004, as it begins to market the products.

ClearLab International's and ClearLab UK's development and manufacturing capabilities also provide the Company with greater access to future contact lens products for the U.S. retail market. This is critical to the Company's strategy should the Company's access to contact lenses from the major contact lens manufacturers be disrupted, curtailed or otherwise negatively impacted, or if the manufacturers do not provide the Company with contact lenses at competitive pricing and with competitive marketing support.

For more information regarding recent transactions by the Company, see Management's Discussion and Analysis of Financial Condition and Results of Operations - Recent Transactions.

## Industry Overview

Industry analysts estimate that over 50% of the United States population needs some form of corrective eyewear. Contact lenses are a convenient, cost-effective alternative to eyeglasses. The number of contact lens wearers is expected to increase as technology further improves the convenience, comfort and fit of contact lenses. As a result, the contact lens market is large and growing. The growth in the disposable market is largely due to the shift in the contact lens market away from traditional soft lenses, which generally are replaced on an annual basis, to disposable lenses, which are generally replaced on a daily, weekly, or bi-weekly basis.

Traditionally, contact lenses were sold to consumers almost exclusively by either ophthalmologists or optometrists (referred to herein collectively as eye care practitioners). Eye care practitioners would typically supply a patient with his or her initial pair of contact lenses in connection with providing the patient an eye examination and subsequently provide replacement lenses. Because the initial fitting of contact lenses requires a prescription written by an eye care practitioner, the initial sale of contact lenses still takes place primarily in this manner. Over the last two decades, however, a number of alternative sellers of replacement contact lenses have emerged, including direct marketers.

The Company believes that increased consumer awareness of the benefits of the direct marketing of contact lenses will lead to further growth of this method of buying and selling contact lenses. Purchasing replacement contact lenses from a direct marketer offers the convenience of shopping at home, rapid home delivery, quick and easy telephone or Internet ordering and competitive pricing. In addition, the growth in popularity of disposable contact lenses, which require patients to purchase replacement lenses more frequently, has contributed to the growth of the direct marketing channel. The direct marketing industry continues to grow as many retail customers have migrated towards the convenience and service offered by home shopping. The Company expects the direct marketing segment of the contact lens industry to grow in tandem with the growth in the direct marketing industry as a whole. Penetration of mail order direct marketing in the contact lens segment of the market remains in the single digit percentage points. This lags in comparison to the penetration of direct marketing of other prescription items such as pharmaceuticals. The company remains optimistic that there is great potential for growth as the contact lens segment enjoys the same growth that the corresponding pharmaceutical market has experienced.

The Company believes that the growth and acceptance of the Internet presents significant opportunities for direct marketers of contact lenses such as the Company. The factors driving this growth include the increasing number and decreasing cost of personal computers in homes and

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offices, technological innovations providing easier, faster and cheaper access to the Internet, the proliferation of content and services being provided on the Internet and the increasing use of the Internet by businesses and consumers as a medium for conducting business.

The Internet possesses a number of unique and commercially powerful characteristics that differentiate it from traditional media: users communicate or access information without geographic limitations; users access

dynamic and interactive content on a real-time basis; and users communicate and interact instantaneously. The Internet has created a dynamic and particularly attractive medium for commerce; empowering customers to gather more comparative purchasing data than is feasible with traditional commerce systems, to shop in a more convenient manner and to interact with sellers in many new ways. The Company believes that the Internet provides a convenient and efficient medium for the sale of replacement contact lenses.

Historically, sales of contact lenses by direct marketers have been impeded by eye care practitioners and contact lens manufacturers. Many eye care practitioners have been reluctant to provide patients with a copy of their prescription or to release such information to direct marketers upon request, thereby limiting a patient's choice to purchase lenses from a direct marketer. Until recently, substantially all of the major manufacturers of contact lenses refused to sell contact lenses directly to direct marketing companies and sought to prohibit their distributors from doing so. These traditional barriers to the direct marketing of contact lenses have been reduced and may be completely eliminated in the future. For example, Congress recently passed the Fairness to Contact Lens Consumers Act ( FCLCA ), requiring all eye care practitioners to give patients a copy of their prescription as soon as they have been fitted, whether they ask for it or not. The FCLCA also requires all eye care practitioners to respond to direct marketers' requests to verify patient prescriptions and provides that their failure to respond within eight business hours shall result in the prescription being presumed valid, thereby eliminating the ability of eye care practitioners to impede sales by direct marketers simply by ignoring or refusing to respond to their requests to verify prescriptions. The regulatory body which oversees the necessity of vigorous competition in the market—the Federal Trade Commission ( FTC ) has been tasked by Congress to study and report its findings on the overall competitiveness of the contact lens market and any recommendations it may have to improve competition. This study and findings may lead to even further pro-consumer initiatives on which the Company may capitalize. Likewise, nearly all of the manufacturers are now subject to legal injunctions requiring them to sell contact lenses to direct marketers under certain conditions or have specific agreements with the Company to supply it contact lenses. See Purchasing and Principal Suppliers and Government Regulation.

### **Product Offerings**

Contact lenses can be divided into two categories: soft lenses and hard lenses (primarily rigid gas permeable). There are three principal wearing regimes for soft contact lenses: conventional, disposable and planned replacement. Conventional lenses are designed to be worn indefinitely but are typically replaced after 12 to 24 months. Disposable soft contact lenses were introduced in the late 1980s based on the concept that changing lenses on a more regular basis was important to comfort, convenience, maintaining healthy eyes and patient compliance. Disposable lenses are changed as often as daily and up to every two weeks, depending on the product. Planned replacement lenses are designed to be changed as often as every two weeks and up to every three months.

The Company has access to all of the major brands and product types in the industry, including spherical, toric, multifocal and colored lenses either directly from the manufacturer or through distributors. The Company's sales by brand and product type are representative of the industry.

The Company maintains the World's largest inventory of contact lenses. Given the proliferation of SKUs in the industry via numerous brands, colored and specialty lenses, the Company's substantial inventory provides contact lens wearers with ready access to their lenses.

The Company is a direct marketer of replacement contact lenses and does not provide eye examinations or related services to its customers. The Company offers substantially all of the soft and hard contact lenses produced by the leading contact lens manufacturers, including Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision. The Company stocks a large inventory of lenses from which it can ship approximately 95% of its orders within one business day of receipt and verification of prescriptions. The Company believes that its large inventory of contact lenses provides it with a competitive advantage over eye care practitioners, optical chains and discount stores and serves as an effective barrier to entry to potential entrants in direct marketing of contact lenses.





The Company purchases products directly from certain manufacturers, including Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, and CooperVision. See Purchasing and Principal Suppliers. The Company's products are delivered in the same sterile, safety sealed containers in which the lenses were packaged by the manufacturer. From time to time, the Company purchases contact lenses that were labeled as samples by the manufacturer. Such lenses are sometimes offered by the Company to customers as part of promotional programs at reduced prices.

The Company's wholly owned subsidiary, ClearLab International, manufactures injection cast molded soft contact lenses on a contract basis for various contact lens manufacturers. ClearLab International also manufactures and distributes branded and private label contact lenses via distributors and other sales channels internationally. ClearLab International produces a wide range of frequent replacement spherical and toric lenses and is focused on developing new lens materials.

On February 24, 2004, the Company completed the acquisition of VisionTec (now known as ClearLab UK), a developer and manufacturer of daily contact lenses based in the United Kingdom. ClearLab UK has developed a method for low cost, high quality production of daily disposable contact lenses using a unique proprietary material. The business will operate as a manufacturing affiliate of ClearLab International. The Company has recently completed the testing of its manufacturing capabilities for ClearLab UK's daily products and is currently expanding its production capabilities. The Company will increase its product offerings to the international markets in fiscal 2004, as it begins to market the products.

Based on previously conducted test marketing, the Company believes that its customers are receptive to an offer from the Company to try both a new product and a new eye care practitioner. The Company believes that a more active role in the product/provider decision may help it address the policies of certain manufacturers that continue to refuse to sell certain brands to the Company and seek to sell these same brands exclusively to eye care practitioners. The Company also believes that by educating consumers as to specific eye care practitioners' anti-consumer activities - and as appropriate, recommending more consumer focused eye care practitioners - that it can influence the consumer decision making process which will directly affect overall practices in the industry. The Company's first preference is to sell to the customer the lens she is already wearing. In cases where manufacturers or eye care practitioners stand in the way of the customer's choice to purchase from the Company, the Company will be able to offer the customer the opportunity to try an alternative eye care provider and an alternative product.

The Company also offers certain products related to contact lenses including solutions and lens cases for storing contact lenses. The Company offers solutions produced by CIBA Vision and purchased directly from CIBA Vision. The lens cases are produced by and purchased from an outside party on a contract basis.

### **Customers and Marketing**

The Company's direct marketing customers are located principally throughout the United States. The percentage of the Company's customers that are located in each state is approximately equal to the percentage of the United States population, which resides in such state, with the largest concentration of the Company's customers residing in California. The Company strives to deliver a high level of customer service in an effort to maintain and expand its loyal customer base. The Company utilizes a focused marketing strategy that is designed to enhance the awareness and value of its brand. The Company continually researches and analyzes new ways in which to advertise its products. After identifying an attractive potential new advertisement or advertising medium, the Company commits to such advertising for an initial test period. After the initial test period, the Company continues to closely monitor its advertising in order to identify and react to trends and patterns as appropriate.

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The majority of contact lens wearers are between the ages of 14 and 49. Approximately two-thirds of contact lens wearers are women and contact lens wearers generally have higher incomes than eyeglass wearers do. Through its national advertising campaign, the Company is able to target its advertising to contact lens wearers in these key demographic groups, as well as certain other persons based on other important demographics.

During 2003, the Company spent approximately \$20.2 million on advertising and intends to increase advertising spending in fiscal 2004 as it continues its nationwide advertising campaign. The Company's advertising campaign targets both its traditional telephone customers and its online customers and is designed to drive new and repeat purchases. In addition, the Company intends to continue its direct marketing campaign to its more than 5 million customers through the U.S. mail and e-mail.

A brief description of the principal components of the Company's national advertising campaign is set forth below:

*Broadcast.* The Company utilizes a nationwide broadcast advertising campaign with significant purchases on both cable and network television. The Company's television ads typically focus on making the process of replacing contact lenses easier for consumers by rapidly delivering to customers the same contact lenses offered by eye care practitioners and by streamlining an otherwise complicated process of ordering prescription medical devices from an alternative seller. The Company believes that its easy-to-remember phone number and Internet addresses make television a particularly effective marketing vehicle and that television advertising will continue to be the key to building awareness for its 1-800 CONTACTS brand name.

*Internet.* The Company uses the Internet as a means of marketing in an effort to drive new and repeat traffic. The Company uses emails as an effective tool to provide reminders to existing customers when it is time to reorder. The Company continues to seek opportunities to expand its presence within highly trafficked content sites.

*Direct-Mailing.* The Company uses direct-mail to advertise its products to selected groups of consumers. The Company utilizes mailing lists obtained from both private and public sources to target its advertisements specifically to contact lens wearers.

*Cooperative Mailings.* The Company advertises its products in cooperative mail programs sponsored by the leading cooperative mail companies in the United States. This advertising medium permits the Company to target consumers in specific zip codes according to age, income and other important demographics.

ClearLab International markets its products internationally and is expected to market ClearLab UK products in 2004. Based on previous test marketing, the Company believes that its customers are receptive to an offer from the Company to try both a new product and a new eye care practitioner. The Company believes that a more active role in the product/provider decision may help it address the policies of certain manufacturers that continue to refuse to sell their brands to the Company and seek to sell their brands exclusively to eye care practitioners. The Company also believes that by educating consumers as to specific eye care practitioners' anti-consumer activities - and as appropriate, recommending more consumer focused eye care practitioners - that it can influence the consumer decision making process which will directly affect overall practices in the industry. The Company's first preference is to sell to the customer the lens she is already wearing. In cases where manufacturers or eye care practitioners stand in the way of the customer's choice to purchase from the Company, the Company will be able to offer the customer the opportunity to try an alternative eye care provider and an alternative product.

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ClearLab International's customers include various international contact lens manufacturers and distributors. ClearLab International currently manufactures frequent replacement disposable lenses for one of the leading contact lens manufacturers.

## Operations

### *Direct Marketing*

The primary components of the Company's direct marketing operations include its teleservices, order entry, Internet order taking, prescription verification, doctor referral network, customer service and distribution and fulfillment.

*Teleservices, Order Entry, Internet Order Taking and Customer Service.* The Company provides its customers with toll-free telephone access to its Customer Service Representatives ( CSRs ). The Company's call center generally operates from 6:00 a.m. to 10:00 p.m. (MST) Monday through Thursday, 6:00 a.m. to 9:00 p.m. (MST) on Friday, 7:00 a.m. to 9:00 p.m. (MST) on Saturday and 8:00 a.m. to 4:00 p.m. (MST) on Sunday. Customers may place orders via the Internet 24 hours a day, 7 days a week. Potential customers may also obtain product, pricing or other information over the Internet or through an interactive voice response system. The Company's orders are received by phone, Internet, mail, facsimile and electronic mail. CSRs process orders directly into the Company's proprietary management information systems, which provide customer order history and information, product specifications, product availability, expected shipping date and order number. CSRs are provided with a sales script and are trained to provide information about promotional items. Additionally, CSRs are trained to provide customer service and are authorized to resolve all customer service issues, including accepting returns and issuing refunds, as appropriate.

The Company believes its customers are particularly sensitive to the way merchants and salespeople communicate with them. The Company strives to hire energetic, service-oriented CSRs who can understand and relate to customers. CSRs participate in an extensive training program. The Company also has a quality assurance department. This department monitors and reviews the CSRs' performance and coaches the CSRs as necessary.

The Company continually upgrades and enhances its management information systems. The Company believes its management information systems have the capacity to handle up to 30,000 calls per day. The Company's CSRs currently handle approximately 8,000 calls per day.

*Prescription Verification.* The sale and delivery of contact lenses are governed by both federal and state laws and regulations, including the recently enacted federal Fairness to Contact Lens Consumer Act ( FCLCA ). The FCLCA requires that contact lenses only be sold to consumers based on a valid prescription. Satisfying this prescription requirement obligates the seller either to obtain a copy of the prescription itself or to verify the prescription by direct communication with the customer's prescriber. Consistent with this requirement, the Company's current operating practice is to require all customers to provide either a valid copy of their prescription or the contact information for their prescriber so that the Company can verify their prescription by direct communication with their prescriber. If the Company does not have a valid copy of the customer's prescription, the Company directly communicates to the customer's prescriber the precise prescription information received from the customer and informs the prescriber that it will proceed with the sale based on this prescription information unless the prescriber advises it within eight business hours that such prescription information is expired or otherwise invalid. If the prescriber properly advises the

Company within this time period that the customer's prescription is expired or otherwise invalid, the Company's practice is to cancel the customer's order. On the other hand, if the prescriber either advises the Company that the prescription is valid or fails to properly respond within the communicated time period, the Company's practice is to complete the sale based on the prescription information communicated to the prescriber, as expressly permitted by the FCLCA. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with the customer's prescriber. The Company believes that it is complying with the regulations of the new federal Act. See Government Regulation .

*Internet.* The Company's principal websites, [www.contacts.com](http://www.contacts.com) and [www.1800contacts.com](http://www.1800contacts.com), provide customers with a quick, efficient and cost-effective source for obtaining replacement contact lenses 24 hours a day, 7 days a week. The Company is continually upgrading the content and functionality of its website. The website allows customers to easily browse and purchase substantially all of the Company's products, promotes brand loyalty and

encourages repeat purchases by providing an inviting customer experience. The Company has designed its website to be fast, secure and easy to use and to enable its customers to purchase products with minimal effort. The Company also offers Internet customers services such as free shipping, shipping confirmation and online order tracking. During the call center's operating hours, the Company offers service and support to its Internet customers over the telephone. The Company also provides e-mail support to customers 24 hours a day, 7 days a week. The Company's website allows customers to dispense with providing personal profile information after their initial order. The website has permitted the Company to expand its customer base through better service while reducing transaction costs.

The Company's online service automates the processing of customer orders, interacts with the management information systems and allows the Company to gather, store and use customer and transaction information in a comprehensive and cost-efficient manner. The Company's website contains customized software applications that interface with the Company's management information systems.

The Company maintains a database containing information compiled from customer profiles, shopping patterns, sales data and eye care practitioner prescribing habits. The Company analyzes information in this database to develop targeted marketing programs and provide personalized and enhanced customer service. This database is scaleable to permit large transaction volumes. The Company's systems support automated e-mail communications with customers to facilitate confirmations of orders, provide customer support, obtain customer feedback and engage in targeted marketing programs.

The Company uses a combination of proprietary and industry-standard encryption and authentication measures designed to protect a customer's information. The Company maintains an Internet firewall to protect its internal systems and all credit card and other customer information.

*Doctor Referral Network.* The company has a referral agreement with Cole National and select independent practitioners nationally. When a customer's prescription is found to be invalid or expired, the Company can now facilitate the process of obtaining an eye examination. This process minimizes the interruptions in product consumption for the consumer and improves the Company's ability to retain its customers.

*Distribution and Fulfillment.* Approximately 95% of the Company's orders are shipped within one business day of receipt and verification of prescriptions. Customers generally receive orders within one to five business days after shipping, depending upon the method of delivery chosen by the customer. A shipping and handling fee is generally charged on each customer order, except those orders received via the Internet and those received by mail with an enclosed check. Customers have the option of having their order delivered by overnight courier for an additional charge. The Company's management information systems automatically determine the anticipated delivery date for each order.

The Company uses an integrated packing and shipping system via a direct connection to the Company's management information systems. This system monitors the in-stock status of each item ordered, processes the order and generates warehouse selection tickets and packing slips for order fulfillment operations. The Company's management information systems are specifically designed with a number of quality control features to help ensure the accuracy of each order.



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The Company's distribution center is approximately 84,000 square feet and is strategically located near the Salt Lake City, Utah international airport.

### *Customer Service*

On June 30, 2003, the Company and Cole National Corporation ( Cole ) announced that they had signed an agreement under which the Company's customers can receive discounted eye exams and value pricing on eyeglasses, sunglasses and other vision products that the Company does not sell from a network of doctors contracted with Cole Managed Vision and associated with more than 1,500 Pearle Vision, Pearle VisionCare, Sears Optical and Target

Optical stores in the U.S. Cole will offer its network of doctors for at least one year. The Company will retain the contact lens business of customers referred to Cole stores.

As part of the agreement, the Company and Cole are also working together on a variety of cross-marketing programs and promotions of their respective products in select test markets. The goal of these cross-marketing programs is to find other ways that the Company and Cole can help create value together.

The Company believes this is a unique offering for Internet, phone or mail order companies, allowing it to recapture customer orders that would otherwise need to be cancelled under Federal law.

### ***Manufacturing***

Prior to the acquisition of ClearLab UK, all of ClearLab International's products were manufactured in one production facility located in Singapore. See Properties. This facility currently has the capacity to produce in excess of 40 million lenses annually and is operating at approximately 40 to 45 percent of capacity. ClearLab International manufactures its soft contact lenses by way of injection cast molding of plastic molds in which it doses various polymers. This process yields dry lenses which are then hydrated to their final wet state in order to become a complete lens. ClearLab International also has the ability to wet cast mold lenses. In wet cast molding, the lenses are formed fully hydrated. With the acquisition of ClearLab UK, the Company has added an additional production facility in the UK. The Company will have the capability to develop and manufacture daily contact lenses in this facility using a unique proprietary process.

### **Management Information Systems**

The Company has developed proprietary management information systems that integrate the Company's order entry and order fulfillment operations. The Company is continually upgrading and enhancing these systems and believes that these systems enable it to operate efficiently and provide enhanced customer service. The key features of these management information systems are their ability to: (i) process numerous types of orders, including telephone, Internet and others; (ii) continually monitor and track the Company's inventory levels for substantially all of its products; (iii) rapidly process credit card orders; (iv) increase the speed of the shipping process with integrated and automated shipping functions; (v) increase accuracy through the scanning of each order prior to shipment to ensure it contains the correct quantity and type of lenses and (vi) communicate directly with eye care provider's offices to accurately verify contact lens prescriptions.

The management information systems provide the Company's CSR with real-time product availability information for substantially all of its products through a direct connection with the Company's distribution center, whereupon information is immediately updated as lenses are shipped. In addition, Internet customers can obtain real-time product availability information for many products. The management information systems also have an integrated direct connection for processing credit card payments which allows the CSR to ensure that a valid card number and authorization have been received in approximately five seconds while the CSR is on the phone with the customer. CSRs also have access to records of all prior contact with a customer, including the customer's address, prescription information, order history and payment history and notes of any prior contact with the customer made by phone, Internet, e-mail, mail or fax. Based on product availability provided by the management information systems, the CSR provides the customer with an estimated date of delivery of their lenses. If a customer's order will not be shipped by the promised delivery date, the management information systems notify the CSR who entered the order and provide any information explaining the delay, and the CSR contacts the customer to inform them of the delay.

After an order has been entered into the management information systems either by a CSR or directly by a customer through the company's order entry system on its internet website, it is sent through the Company's verification process to attempt to confirm the validity of the prescription. Once it is verified or the verification hold time has elapsed (see Government Regulations section) it is sent to the Company's distribution center via a direct connection. If the prescription is expired or determined to be invalid during the verification process, the order is then cancelled and the customer's information is made available to the Company's national doctor network department to

inform the customer of the cancellation. At this time one of the Company's doctor network specialists offers to assist the customer by referring the customer to a Cole National or independent doctor within its national doctor referral network, which includes independent eye care practitioners as well as those participating in the Cole agreement, and provides the customer with promotional offers which includes an offer for a discounted eye exam.

After the distribution center receives an order, the invoice for the order is printed and the customer's credit card is charged, if applicable. The invoice for each order contains the type and quantity of the lenses, as well as a shipping label for the order. Tracking, manifesting, billing and other shipping functions are integrated into the Company's management information systems so that all necessary bar codes and tracking information for shipment via independent couriers are printed directly on the Company's shipping label, and separate labeling or a separate computer is not needed to ship packages via independent couriers.

After the invoice for an order is printed at the Company's distribution center, the order is pulled from inventory and scanned to ensure that the prescription and quantity of each item matches the order in the Company's management information systems. Audible notices inform the shipping agent of any errors in the order. After the order has been scanned for accuracy, the management information systems update the Company's inventory level. Then the order is placed in a box folded by the Company's automated box folder and is sent to an automatic sealer. After the package leaves the sealer, another scanner reads the bar code on the shipping label to determine which method of shipment is being used, adds the package to the appropriate carrier's manifest and directs the appropriate hydraulic diverter to push the package into the appropriate carrier's shipping bin.

The Company has installed a battery powered back-up system capable of supporting its entire call center, computer room and phone switch. This system is further protected by a generator capable of supporting the Company's call center operations for a period of five days. All critical data is simultaneously written to a series of back-up drives throughout the day and at the end of the day the Company's data is transmitted to various offsite locations as well as an onsite fireproof safe. There can be no assurance that the Company's back-up system will be sufficient to prevent an interruption in the Company's operations in the event of disruption in the Company's management information systems, and an extended disruption in the management information systems could adversely affect the Company's business, financial condition and results of operations.

### **Purchasing and Principal Suppliers**

Until recently, substantially all of the major manufacturers of contact lenses refused to sell lenses to direct marketers, including the Company, and sought to prohibit their distributors from doing so. After opening direct accounts with Ciba Vision and Bausch and Lomb, the Company began buying directly from Johnson & Johnson Vision Care during March 2003. Currently, Ocular Sciences is the only remaining major manufacturer who refuses to sell directly to the Company. Historically, the Company has purchased a substantial portion of its products from unauthorized distributors, but currently the Company purchases the majority of its products directly from the manufacturers with the exception of all Ocular Sciences products and select CooperVision products. The purchases from unauthorized distributors are expected to decrease in the future as the Company expands its purchasing relationships in the industry and as Federal regulatory authorities analyze the business practices of manufacturers which refuse to sell to direct marketing companies.

As a result of some manufacturers' refusal to sell to the Company, the Company is not an authorized dealer for some of the products it sells. In addition, the Company believes that the price which it pays for certain products is sometimes higher than those paid by eye care practitioners, retail chains and mass merchandisers, who are able to buy directly from the manufacturers of such lenses and who benefit from being allowed to participate in cooperative advertising funds, coupon, sample, rebate and other marketing and promotional programs. Although the Company has been able to obtain most contact lens brands at competitive prices in sufficient quantities on a regular basis, there can be no assurance that the

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Company will not encounter difficulties in the future. The inability of the Company to obtain sufficient quantities of contact lenses at competitive prices would have a material adverse effect on the Company's business, financial condition and results of operations.

Although the Company seeks to reduce its reliance on any one supplier by establishing relationships with a number of distributors, manufacturers and other sources, the Company acquired from a single distributor approximately 46 percent, 35 percent and 23 percent of its contact lenses purchased in fiscal 2001, 2002 and 2003, respectively. The Company's top three suppliers accounted for approximately 70 percent, 63 percent and 59 percent of the Company's inventory purchased in fiscal 2001, 2002 and 2003, respectively. The Company continually seeks to establish new relationships with potential suppliers in order to obtain adequate inventory at competitive prices. In the event that these suppliers could no longer supply the Company with contact lenses, there can be no assurance that the Company could secure other adequate sources of supply, or that such supply could be obtained on terms no less favorable to the Company than its current supply, which could adversely affect the Company by increasing its costs or, in the event adequate replacement supply cannot be secured, reducing its net sales. In that regard, the Company does not have any contracts with manufacturers or distributors of contact lenses which provide for an absolute guarantee of supply to the Company.

During the latter part of 2003, the Company reached agreements with its top three vendors for improved pricing and marketing support. This support will come in the form of cooperative marketing and proprietary rebate programs designed to promote the manufacturer's products and build sales. The Company believes it is one of the largest U.S. customers for the three largest contact lens manufacturers.

ClearLab International has developed a new brand of contact lenses that is expected to provide the Company increased control of inventory and the flexibility with which to make a variety of offers to its customers and to enhance its capability to provide high quality, cost-effective products. These manufacturing capabilities also provide the Company with greater access to contact lens products for future distribution in the U.S. should the Company's access to contact lenses from the major contact lens manufacturers be disrupted, curtailed or otherwise negatively impacted, or if the manufacturers do not provide the Company with contact lenses at competitive pricing and with competitive marketing support.

## **Competition**

The retail sale of contact lenses is a highly competitive and fragmented industry. Traditionally, contact lenses were sold to customers almost exclusively by eye care practitioners in connection with providing them an eye examination. Competition for patients and the revenue related to providing contact lenses to those customers significantly increased as optical chains and large discount retailers began providing optical services and has further intensified with the entry of direct marketers such as the Company. The Company believes that the eye care profession suffers from a surplus of eye care practitioners and that the resulting competitive pressure has been exacerbated by the increased prevalence of retail optical chains, mass merchandisers and direct marketers. Consequently, the competition amongst eye care practitioners to acquire customers and the competition to provide replacement lenses to such customers has intensified. To a lesser extent, the Company also competes with manufacturers of eyeglasses and providers of other vision correction, including refractive surgical procedures.

The Company's principal competitors include ophthalmologists and optometrists in private practice. The Company also competes with national optical chains, such as Cole Vision, LensCrafters and National Vision Association and mass merchandisers, such as Wal-Mart, Sam's Club and Costco. In addition, the Company competes with other direct marketers of contact lenses. The Company may face increased competition in the future from new entrants in the direct marketing business, which may include national optical chains and mass merchandisers, some of which may have significantly greater resources than the Company.

The Company believes that many of its competitors, including most eye care practitioners, national optical chains and mass merchandisers, have direct supply arrangements with contact lens manufacturers which in some cases afford those competitors with better pricing terms, access to supply and other sales and marketing programs. In addition, some of the competitors are significantly larger in overall revenues and have significantly greater resources than the Company. The Company believes that the principal elements of competition in the industry include

price, product availability, customer service and consumer awareness.

In addition, the manufacturing of contact lenses is highly competitive. With respect to its manufacturing operations, the Company faces competition from other contact lens manufacturers such as Johnson & Johnson Vision Care, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision. Most of the Company's competitors have substantially greater resources to invest in product development and customer support, and greater access to financial and other resources than the Company.

### **Government Regulation**

#### ***Direct Marketing***

#### ***Federal Regulation***

Contact lenses are regulated by the Food and Drug Administration ( FDA ) as medical devices. The FDA classifies medical devices as Class I, Class II or Class III and regulates them to varying degrees, with Class I medical devices subject to the least amount of regulation and Class III medical devices subject to the most stringent regulations. Rigid gas permeable and soft contact lenses are classified as Class II medical devices if intended only for daily wear and as Class III medical devices if intended for extended wear. These regulations generally apply only to the manufacturing of contact lenses, and therefore do not directly impact the direct marketing operations of the Company. Federal regulations also require the labels on medical devices to contain adequate instructions for their safe and proper use. However, there is an exemption from this requirement for medical devices the use of which is not safe except under the supervision of a practitioner licensed by law to direct the use of such device. Devices which fall within this exception must contain as part of their labeling the statement "Caution: Federal law restricts this device to sale by or on the order of \_\_\_\_\_ (physician or other licensed practitioner), the blank to be filled in with the word physician or other practitioner authorized by the law of the state in which the practitioner practices to use or order the use of the device. The FDA considers contact lenses to qualify for this labeling exemption; however, a device bearing this legend that is di