

CHARLOTTE RUSSE HOLDING INC  
Form 10-Q  
July 28, 2006  
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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 24, 2006**

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

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COMMISSION FILE NUMBER 000-27677

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**CHARLOTTE RUSSE HOLDING, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**DELAWARE**  
(State or Other Jurisdiction of Incorporation)

**33-0724325**  
(I.R.S. Employer Identification No.)

**4645 MORENA BOULEVARD**

**SAN DIEGO, CA**  
(Address of Principal Executive Offices)

**92117**  
(Zip Code)

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(858) 587-1500

(Registrant's Telephone Number, Including Area Code)

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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.

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:

The number of shares of common stock outstanding as of July 20, 2006 was 22,587,114.

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**Table of Contents****CHARLOTTE RUSSE HOLDING, INC.****CONSOLIDATED BALANCE SHEETS**

	June 24,	September 24,
	2006	2005
	(Unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 65,537,057	\$ 33,635,738
Inventories	52,692,656	46,123,493
Other current assets	6,418,746	11,090,971
Deferred tax assets	15,700,000	7,450,000
Current assets of discontinued operations	2,852,433	12,021,409
	<hr/>	<hr/>
Total current assets	143,200,892	110,321,611
Fixed assets, net	163,454,046	166,849,301
Goodwill	28,790,000	28,790,000
Other assets	529,187	590,682
Non-current assets of discontinued operations		22,584,085
	<hr/>	<hr/>
Total assets	\$ 335,974,125	\$ 329,135,679
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable, trade	\$ 27,002,690	\$ 28,077,402
Accounts payable, other	6,019,287	6,776,763
Accrued payroll and related expense	6,474,829	3,219,924
Income and sales taxes payable	4,307,367	3,095,810
Other current liabilities	8,146,137	10,025,645
Current liabilities of discontinued operations	15,325,738	7,457,456
	<hr/>	<hr/>
Total current liabilities	67,276,048	58,653,000
Deferred rent	92,514,423	91,852,936
Other liabilities	43,705	43,894
Deferred tax liabilities	1,060,000	1,440,000
Non-current liabilities of discontinued operations		10,035,615
	<hr/>	<hr/>
Total liabilities	160,894,176	162,025,445
Commitments and contingencies		
Stockholders' equity:		
Preferred Stock \$0.01 par value, 3,000,000 shares authorized, none issued and outstanding		
Common Stock \$0.01 par value, 100,000,000 shares authorized, issued and outstanding shares and 22,037,432 at June 24, 2006 and September 24, 2005, respectively.	22,587,114	22,037,432
	<hr/>	<hr/>
Additional paid-in capital	225,871	220,375
Retained earnings	57,332,588	50,724,713
	<hr/>	<hr/>
	117,521,490	116,165,146

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Total stockholders' equity	175,079,949	167,110,234
Total liabilities and stockholders' equity	\$ 335,974,125	\$ 329,135,679

*See accompanying notes.*

**Table of Contents****CHARLOTTE RUSSE HOLDING, INC.****CONSOLIDATED STATEMENTS OF INCOME****(Unaudited)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 24, 2006</b>	<b>June 25, 2005</b>	<b>June 24, 2006</b>	<b>June 25, 2005</b>
Net sales	\$ 162,617,516	\$ 123,267,397	\$ 498,310,599	\$ 362,232,660
Cost of goods sold, including buying, distribution and occupancy costs	117,304,051	91,813,683	365,120,079	271,149,460
Gross profit	45,313,465	31,453,714	133,190,520	91,083,200
Selling, general and administrative expenses	31,278,099	26,191,977	96,660,460	78,164,371
Operating income	14,035,366	5,261,737	36,530,060	12,918,829
Other income (expense):				
Interest income, net	699,038	217,480	1,645,829	566,590
Other charges, net	(62,499)	(72,877)	(191,684)	(198,576)
Total other income	636,539	144,603	1,454,145	368,014
Income from continuing operations before income taxes	14,671,905	5,406,340	37,984,205	13,286,843
Income taxes	5,824,740	1,909,172	15,079,722	4,982,567
Income from continuing operations	8,847,165	3,497,168	22,904,483	8,304,276
Loss on discontinued operations, net of tax (which includes an impairment charge of \$13.6 million in the nine months ended June 24, 2006)	(2,969,054)	(182,302)	(21,548,139)	(3,589,830)
Net income	\$ 5,878,111	\$ 3,314,866	\$ 1,356,344	\$ 4,714,446
Earnings (loss) per share basic:				
Continuing operations	\$ 0.39	\$ 0.16	\$ 1.02	\$ 0.38
Discontinued operations	(0.13)	(0.01)	(0.96)	(0.17)
Earnings per basic share	\$ 0.26	\$ 0.15	\$ 0.06	\$ 0.21
Earnings (loss) per share diluted:				
Continuing operations	\$ 0.36	\$ 0.15	\$ 0.93	\$ 0.35
Discontinued operations	(0.12)	(0.01)	(0.87)	(0.15)
Earnings per diluted share	\$ 0.24	\$ 0.14	\$ 0.06	\$ 0.20

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Weighted average shares outstanding:				
Basic	22,542,342	22,006,815	22,399,037	21,982,838
	<u>                    </u>	<u>                    </u>	<u>                    </u>	<u>                    </u>
Diluted	24,787,745	24,052,762	24,639,658	24,016,939
	<u>                    </u>	<u>                    </u>	<u>                    </u>	<u>                    </u>

*See accompanying notes.*

**Table of Contents****CHARLOTTE RUSSE HOLDING, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 24, 2006</b>	<b>June 25, 2005</b>	<b>June 24, 2006</b>	<b>June 25, 2005</b>
<b>Operating Activities</b>				
Net income	\$ 5,878,111	\$ 3,314,866	\$ 1,356,344	\$ 4,714,446
Adjustments to reconcile net income to net cash provided by operating activities of continuing operations				
Net loss from discontinued operations	2,969,054	182,302	21,548,139	3,589,830
Depreciation and amortization	8,942,973	7,157,025	24,802,295	20,717,517
Amortization of construction allowances	(2,859,148)	(2,482,337)	(8,452,743)	(6,842,054)
Landlord construction allowances	3,262,205	5,189,317	8,111,218	10,099,368
Stock based compensation	492,000		1,428,000	
Deferred rent	460,354	711,778	1,003,012	1,387,073
Loss on disposal of assets	101,857	401,268	349,795	278,285
Deferred income taxes	(30,000)	(2,300,000)	302,500	(2,200,000)
Changes in operating assets and liabilities				
Inventories	(3,128,644)	(7,403,800)	(6,569,163)	(3,856,104)
Other current assets	(245,884)	1,537,953	4,672,225	1,622,580
Accounts payable, trade	(1,222,665)	(1,082,456)	(1,074,712)	2,978,553
Accounts payable, other	917,315	3,278,951	(757,476)	(2,210,825)
Accrued payroll and related expense	1,963,080	1,583,297	3,254,905	827,701
Income and sales taxes payable	1,302,246	46,892	1,211,557	505,974
Other current liabilities	(344,519)	45,122	(1,879,697)	44,346
Net cash provided by operating activities of continuing operations	18,458,335	10,180,178	49,306,199	31,656,690
Net cash provided by (used in) operating activities of discontinued operations	2,494,363	(472,800)	559,719	1,167,608
Net cash provided by operating activities	20,952,698	9,707,378	49,865,918	32,824,298
<b>Investing Activities</b>				
Purchases of fixed assets	(8,683,560)	(15,901,697)	(22,047,104)	(29,151,383)
Other assets	(3,883)	(13,805)	16,495	(29,291)
Net cash used in investing activities of continuing operations	(8,687,443)	(15,915,502)	(22,030,609)	(29,180,674)
Net cash used in investing activities of discontinued operations	(930,796)	(48,831)	(1,119,361)	(1,031,266)
Net cash used in investing activities	(9,618,239)	(15,964,333)	(23,149,970)	(30,211,940)
<b>Financing Activities</b>				
Proceeds from issuance of common stock	1,353,800	109,320	3,334,044	358,905
Excess tax benefits from option exercises	260,880	44,481	1,851,327	82,148



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Net cash provided by financing activities	1,614,680	153,801	5,185,371	441,053
Net increase (decrease) in cash and cash equivalents	12,949,139	(6,103,154)	31,901,319	3,053,411
Cash and cash equivalents at beginning of the period	52,587,918	39,814,458	33,635,738	30,657,893
Cash and cash equivalents at end of the period	\$ 65,537,057	\$ 33,711,304	\$ 65,537,057	\$ 33,711,304

*See accompanying notes.*

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**CHARLOTTE RUSSE HOLDING, INC.**

**Notes to Consolidated Financial Statements (Unaudited)**

**1. Interim Financial Statements**

The accompanying unaudited consolidated financial statements of Charlotte Russe Holding, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures required by accounting principles generally accepted in the United States for complete financial statements have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, the accompanying unaudited financial statements contain all material adjustments, including normal recurring accruals, necessary to present fairly the Company's financial position, results of operations and cash flows for the periods indicated, and have been prepared in a manner consistent with the audited financial statements for the fiscal year ended September 24, 2005.

Certain amounts in the prior periods' financial statements have been reclassified to conform with the third quarter of fiscal 2006 presentation. As discussed in Note 2 below, management's decision to sell certain assets of its Rampage stores resulted in a financial statement reclassification of all but seven of the 64 stores as being held for sale at June 24, 2006. This group of assets was deemed to represent a component of the Company, and the financial statements have been reclassified to reflect them as discontinued operations. The Company expects to classify the operations of the remaining seven stores when such locations are converted or abandoned in the fourth quarter of fiscal 2006.

Due to the seasonal nature of the Company's business, the results of operations for the three and nine month periods ended June 24, 2006 are not necessarily indicative of the results of a full fiscal year.

These financial statements should be read in conjunction with the audited financial statements and the footnotes for the fiscal year ended September 24, 2005 included in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on December 7, 2005.

**2. Discontinued Operations and Impairment**

The Company's efforts to reposition the Rampage stores proved unsuccessful and management determined that sufficient indicators of impairment of the Rampage long-lived assets existed as of March 25, 2006. These assets principally consisted of the store leasehold improvements, store fixtures and store equipment. As a result, a \$22.5 million non-cash impairment charge was recorded in the second quarter of fiscal 2006 to write down substantially all of the carrying value of the Rampage long-lived assets as of March 25, 2006.

During the third quarter of fiscal 2006 management completed an evaluation of the strategic alternatives for the Rampage stores. That review indicated that certain assets of a majority of the 64 Rampage stores could be sold, based upon specific interest shown by other retailers, while the

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remaining stores could either be closed or converted to the Charlotte Russe format.

On June 29, 2006 the Company announced that it had entered into an agreement to sell the leasehold interests, store fixtures and equipment for 44 Rampage store locations. The Company will receive approximately \$14.0 million of sales proceeds from this all-cash transaction, subject to and contingent upon the satisfaction of certain conditions, including receipt of landlord consents with respect to each store. This sale transaction is expected to be reported in the fourth quarter of fiscal 2006 which began on June 25, 2006.

Of the 44 stores subject to the transaction, 24 stores ceased to operate as Rampage stores on July 5, 2006. The remaining 20 stores are expected to cease operations by approximately July 31, 2006. With respect to the 20 Rampage stores not included in this transaction, the Company intends to convert four stores into Charlotte Russe locations and to sell or abandon the remaining Rampage stores within the next 12 months.

**Table of Contents****CHARLOTTE RUSSE HOLDING, INC.****Notes to Consolidated Financial Statements (Unaudited) (Continued)****2. Discontinued Operations and Impairment (continued)**

Other than seven stores which are expected to be converted to Charlotte Russe locations or abandoned in the fourth quarter of fiscal 2006, the Rampage stores operating results have been segregated and shown as discontinued operations in the accompanying Consolidated Statements of Income. Details of those results were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	June 24, 2006	June 25, 2005	June 24, 2006	June 25, 2005
Net sales	\$ 16,707	\$ 23,618	\$ 53,537	\$ 61,611
Loss from operations	\$ 4,924	\$ 157	\$ 13,235	\$ 5,744
Impairment charges			22,500	
	4,924	157	35,735	5,744
Income tax expense (benefit)	(1,955)	25	(14,187)	(2,154)
Net loss on discontinued operations	\$ 2,969	\$ 182	\$ 21,548	\$ 3,590

In addition, the Company has segregated the assets and liabilities related to the Rampage stores and shown them as assets and liabilities of discontinued operations in the accompanying Consolidated Balance Sheets. As of June 24, 2006 the significant components include inventory, accounts payable, trade and deferred rent.

**3. Stock Based Compensation****Stock Plan Activity**

Under the 1999 Equity Incentive Plan (the Plan), the Company grants stock options to purchase common stock to some of its employees and non-employee directors at prices equal to the market value of the common stock on the date of grant. Although the Plan allows for issuance of incentive stock options, stock appreciation rights, restricted stock, unrestricted stock awards, deferred stock awards and performance awards, no such awards have been granted to date. Stock options generally vest ratably over five years and expire after 10 years. Outstanding awards that were previously granted under predecessor plans also remain in effect in accordance with their terms. Stock option activity through the first nine months of fiscal 2006 is as follows:

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	<u>Options</u>	<u>Weighted Average Exercise Price Per Share</u>	<u>Weighted Average Remaining Term</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at September 24, 2005	1,961,970	\$ 11.00	6.4	\$ 7,241,924
Granted	249,500	15.28		
Cancelled	(33,400)	12.13		
Exercised	(384,220)	4.19		\$ 5,039,000
Outstanding at December 24, 2005	1,793,850	13.03	7.5	\$ 12,474,197
Granted	29,500	17.95		
Cancelled	(86,100)	12.84		
Exercised	(25,500)	10.10		\$ 175,815

**Table of Contents****CHARLOTTE RUSSE HOLDING, INC.****Notes to Consolidated Financial Statements (Unaudited) (Continued)****3. Stock Based Compensation (continued)**

	<u>Options</u>	<u>Weighted Average Exercise Price Per Share</u>	<u>Weighted Average Remaining Term</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at March 25, 2006	1,711,750	13.17	7.3	\$ 10,153,045
Granted	12,000	21.18		
Cancelled	(94,500)	12.81		
Exercised	(129,448)	10.46		\$ 1,403,418
Outstanding at June 24, 2006	<u>1,499,802</u>	<u>\$ 13.49</u>	<u>7.1</u>	<u>\$ 12,192,099</u>

Intrinsic value is defined as the difference between the relevant current market value of the common stock and the grant price for options with exercise prices less than the market values on such dates. Cash received from stock options exercised during the nine months ended June 24, 2006 was \$3.3 million and the actual tax benefit realized from these exercises was \$2.4 million.

Options outstanding and exercisable at June 24, 2006 were as follows:

Exercise Prices	Options Outstanding				Options Exercisable		
	Outstanding	Weighted Average Remaining Term	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value	Outstanding	Weighted Average Exercise Price Per Share	Aggregate Intrinsic Value
\$ 3.50 \$10.00	48,600	2.0	\$ 3.87	\$ 860,706	48,600	\$ 3.87	\$ 860,609
\$10.01 \$15.00	1,142,802	7.4	12.21	10,762,857	410,702	11.66	4,126,658
\$15.01 \$20.00	88,500	9.4	17.74	339,840	5,000	17.27	21,575
\$20.01 \$27.00	219,900	5.6	20.54	228,696	169,100	20.57	170,622
	<u>1,499,802</u>	<u>7.1</u>	<u>\$ 13.49</u>	<u>\$ 12,192,099</u>	<u>633,402</u>	<u>\$ 13.49</u>	<u>\$ 5,179,464</u>

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Subject to adjustments for stock splits and similar events, there were a total of 2,250,000 shares authorized under the Plan at September 24, 2005. On February 7, 2006, an additional 1,000,000 shares was authorized by the Company's stockholders. Of the 3,250,000 shares authorized, 1,256,000 were available for future issuance at June 24, 2006. There were 202,164 shares available for future purchase under the Company's Employee Stock Purchase Plan ( ESPP ) at June 24, 2006.

### *Accounting for Stock Based Compensation Expense*

Prior to the beginning of fiscal 2006, the Company did not record compensation expense for its stock based compensation plans, except for options granted just prior to the Company's initial public offering for 120,000 shares, as such treatment was permitted under the provisions of Accounting Principles Board ( APB ) Opinion No. 25 *Accounting for Stock Issued to Employees*, related interpretations, and SFAS 123, *Accounting for Stock-Based Compensation*. The Company provided the requisite pro forma disclosures and complied with provisions of SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosures*.

Effective the beginning of fiscal 2006, the Company adopted the fair value recognition provisions of SFAS 123(R), *Share-Based Payment*, using the modified prospective transition method. Under this transition method, compensation expense includes options vesting for (1) share-based payments granted prior to, but not vested as of September 24, 2005, based on the grant date fair value estimated in accordance with the original

**Table of Contents****CHARLOTTE RUSSE HOLDING, INC.****Notes to Consolidated Financial Statements (Unaudited) (Continued)****3. Stock Based Compensation (continued)**

provisions of SFAS 123; (2) share-based payments granted after September 24, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R); and (3) shares sold under the ESPP after September 24, 2005, based on calculations of fair value which are similar to how stock option valuations are made. Because this transition method was selected, results of prior periods have not been restated.

The Company recognized the following stock based compensation expense for its stock option and employee stock purchase plans during fiscal 2006:

	<b>Three Months Ended June 24, 2006</b>	<b>Nine Months Ended June 24, 2006</b>
Cost of goods sold	\$ 115,522	\$ 373,122
Selling, general and administrative expenses	376,478	1,054,878
Compensation expense	492,000	1,428,000
Income tax benefit	195,324	566,916
Reduction of net income	<b>\$ 296,676</b>	<b>\$ 861,084</b>
Reduction of earnings per share:		
Basic	<b>\$ 0.01</b>	<b>\$ 0.04</b>
Diluted	<b>\$ 0.01</b>	<b>\$ 0.03</b>

As of June 24, 2006, there was \$3.7 million (before any related tax benefit) of total unrecognized compensation expense related to nonvested share based compensation that is expected to be recognized over a weighted average period of 2.0 years. The fair value of shares vested during the three months and nine months ended June 24, 2006, was \$0.7 million and \$2.0 million, respectively.

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of SFAS 123(R) to share based compensation using the Black-Scholes valuation model with straight-line amortization of the expense over the respective vesting periods of the awards:

**Three Months Ended**                      **Nine Months Ended**



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	June 24, 2006	June 25, 2005	June 24, 2006	June 25, 2005
Net income, as reported		\$ 3,314,866		\$ 4,714,446
Less: Share based compensation expense determined under fair value method, net of income taxes		(273,990)		(586,583)
Net income, including share based compensation expense	\$ 5,878,111	\$ 3,040,876	\$ 1,356,344	\$ 4,127,863
Earnings per share:				
Basic as reported	\$ 0.26	\$ 0.15	\$ 0.06	\$ 0.21
Basic pro forma	\$ 0.26	\$ 0.14	\$ 0.06	\$ 0.19
Diluted as reported	\$ 0.24	\$ 0.14	\$ 0.06	\$ 0.20
Diluted pro forma	\$ 0.24	\$ 0.13	\$ 0.06	\$ 0.17

**Table of Contents****CHARLOTTE RUSSE HOLDING, INC.****Notes to Consolidated Financial Statements (Unaudited) (Continued)****3. Stock Based Compensation (continued)**

Prior to the beginning of fiscal 2006, the Company presented the benefit of all tax deductions resulting from stock based compensation plans as operating cash flows in the Statements of Cash Flows. With the adoption of SFAS 123(R) the Company is required to reflect the benefit of tax deductions in excess of the compensation expense recognized in its financial statements for those options ( excess tax credits ) to be classified as a financing cash flow.

**Calculation of Fair Value of Stock Options**

The Company estimates the fair value of stock options granted using the Black-Scholes option valuation model and a multiple option award approach. The expected life of options represents the period of time the options are expected to be outstanding and is based on historical trends and other subjective factors. The expected stock volatility is based on the average of historical volatility of the Company's common stock and other subjective factors. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time awards are granted, and the expected dividend rate takes into account the absence of any historical payments and management's intention to retain all earnings for future operations and expansion.

The following table presents the weighted average assumptions used in the pricing model for stock options granted during the following periods:

	Three Months Ended		Nine Months Ended	
	June 24, 2006	June 25, 2005	June 24, 2006	June 25, 2005
<b>Stock Options:</b>				
Expected life (years)	3.6	4.0	4.0	4.0
Expected volatility	48%	55%	48%	55%
Expected dividend yield	0%	0%	0%	0%
Risk-free interest rate	4.9%	3.9%	4.4%	3.9%
Fair value per option granted	\$ 8.40	\$ 6.06	\$ 6.57	\$ 5.36

**4. Net Income Per Common Share**

Basic earnings per share is calculated based on the weighted average outstanding common shares. Diluted earnings per share is calculated based on the weighted average outstanding shares and potentially dilutive stock options and warrants. In accordance with SFAS No. 128, *Earnings Per Share*, the following table reconciles net income and share amounts utilized to calculate basic and diluted net income per common share.

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	Three Months Ended		Nine Months Ended	
	June 24, 2006	June 25, 2005	June 24, 2006	June 25, 2005
Net income from continuing operations	\$ 8,847,165	\$ 3,497,168	\$ 22,904,483	\$ 8,304,276
Loss on discontinued operations	(2,969,054)	(182,302)	(21,548,139)	(3,589,830)
<b>Net income</b>	<b>\$ 5,878,111</b>	<b>\$ 3,314,866</b>	<b>\$ 1,356,344</b>	<b>\$ 4,714,446</b>
<b>Weighted average number of shares:</b>				
Basic	22,542,342	22,006,815	22,399,037	21,982,838
Effect of dilutive warrants	1,871,932	1,798,739	1,861,679	1,796,284
Effect of dilutive stock options	373,471	247,208	378,942	237,817
<b>Diluted</b>	<b>24,787,745</b>	<b>24,052,762</b>	<b>24,639,658</b>	<b>24,016,939</b>

**Table of Contents****CHARLOTTE RUSSE HOLDING, INC.****Notes to Consolidated Financial Statements (Unaudited) (Continued)****4. Net Income Per Common Share (continued)**

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 24, 2006</b>	<b>June 25, 2005</b>	<b>June 24, 2006</b>	<b>June 25, 2005</b>
Net income from continuing operations per share:				
Basic	\$ 0.39	\$ 0.16	\$ 1.02	\$ 0.38
Effect of dilutive warrants	(0.03)	(0.01)	(0.08)	(0.03)
Effect of dilutive stock options			(0.01)	
Diluted	\$ 0.36	\$ 0.15	\$ 0.93	\$ 0.35

The calculation of dilutive shares excludes the effect of the following options and warrants that are considered anti-dilutive:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 24, 2006</b>	<b>June 25, 2005</b>	<b>June 24, 2006</b>	<b>June 25, 2005</b>
Anti-dilutive options and warrants	32,209	507,692	222,864	528,559

**5. Unredeemed Gift Card Income**

Sales of gift cards are recorded as a liability included within accrued expenses and other current liabilities in the Consolidated Balance Sheets. As the gift cards are redeemed for merchandise, the Company records revenue. Over time, some portion of the gift cards issued is not redeemed. Beginning with the second quarter of fiscal 2006, the liability balance is adjusted to recognize estimated unredeemed amounts under the redemptive recognition method. This method records gift card breakage as additional sales on a proportional basis over the redemption period based on historical redemption trends. The Company's net sales for the second quarter of fiscal 2006 included an adjustment of \$2.0 million to reduce gift card liabilities for estimated unredeemed amounts as of the beginning of the second quarter and an additional reduction of \$0.4 million for unredeemed gift card liability which represented activity during the quarter. The Company's net sales for the third quarter of fiscal 2006 included a reduction of \$0.1 million to reduce gift card liabilities and record revenue for estimated unredeemed amounts which represented

activity during the quarter.

## **6. Recent Accounting Pronouncements**

In October 2005, the FASB issued FASB Staff Position Financial Accounting Standard ( FSP FAS ) 13-1, *Accounting for Rental Costs Incurred during Construction Period*. FSP FAS 13-1 clarifies the accounting for rental costs associated with operating leases that are incurred during a construction period. In addition, FSP FAS 13-1 requires that a lessee shall cease capitalizing rental costs as of the effective date of FSP FAS 13-1 for operating lease arrangements entered into prior to the effective date of FSP FAS 13-1. FSP FAS 13-1 is effective for periods beginning after December 15, 2005. The adoption of FSP FAS 13-1 did not have a material impact on the Company's operating results or financial condition.

## **7. Commitments and Contingencies**

On December 14, 2004, plaintiff David Phillips, on behalf of himself and purportedly on behalf of a class of others similarly situated, filed a complaint seeking damages in the United States District Court for the Southern District of California against the Company and two of the Company's officers, alleging violations of federal

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**CHARLOTTE RUSSE HOLDING, INC.**

**Notes to Consolidated Financial Statements (Unaudited) (Continued)**

**7. Commitments and Contingencies (continued)**

securities laws related to declines in the Company's stock price in connection with various statements and alleged omissions to the public and to the securities markets. Two follow-on actions were filed in the same court alleging substantially similar claims, and on April 25, 2005, all these claims were consolidated into a single action. On October 31, 2005, the Company reached an agreement in principle (subject to final court approval) to settle the securities litigation pending against the Company and certain of the Company's officers and directors for the sum of \$3.9 million, paid mostly by the Company's insurance carrier. In the fourth quarter of fiscal 2005, the Company incurred a pre-tax charge of approximately \$600,000 associated with defense and settlement costs. On March 14, 2006, the court entered an order granting preliminary approval of the settlement. A final settlement hearing was held on June 8, 2006. The court took the matter under submission and stated that it would rule after the filing of an additional document by plaintiffs.

In addition to the foregoing, from time to time, the Company may be involved in litigation relating to claims arising out of its operations. As of the date of this filing, the Company is not engaged in any legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on the Company's business, financial condition or results of operations.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****FORWARD-LOOKING STATEMENTS**

We have made statements in this Quarterly Report on Form 10-Q that are forward-looking statements. You can identify these statements by forward-looking words such as may, will, expect, intend, anticipate, believe, estimate and continue or similar words. These forward-looking statements may also use different phrases. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements, which are subject to risks, uncertainties, and assumptions about us, may include, among other things, projections of our future results of operations or of our financial condition, and statements about our anticipated growth strategies.

There may be events in the future that we are not able to accurately predict or which we do not fully control that could cause actual results to differ materially from those expressed or implied in our forward-looking statements. Because these forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements. These risks and uncertainties include, but are not limited to, the risk that the conditions to the receipt of the sales proceeds from the Rampage transaction will not be satisfied and that we will not receive such sales proceeds, general and regional economic conditions, industry trends, consumer demands and preferences, competition from other retailers and uncertainties generally associated with women's apparel and accessory retailing. A more detailed description of these factors, as well as others that could affect our business, is set forth in Risk Factors below and in our Annual Report on Form 10-K, filed with the Securities and Exchange Commission on December 7, 2005.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**RESULTS OF OPERATIONS**

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our Consolidated Financial Statements and Notes thereto included elsewhere in this Quarterly Report on Form 10-Q. The following table sets forth our operating results, expressed as a percentage of net sales, and store numbers for the periods indicated. These operating results are not necessarily indicative of the results that may be expected for any future period.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>June 24, 2006</b>	<b>June 25, 2005</b>	<b>June 24, 2006</b>	<b>June 25, 2005</b>
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	72.1	74.5	73.3	74.8
Gross profit	27.9	25.5	26.7	25.2
Selling, general and administrative expenses	19.3	21.2	19.4	21.6
Operating income	8.6	4.3	7.3	3.6
Interest income, net	0.4	0.2	0.3	0.2

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Other charges, net	0.0	(0.1)	0.0	(0.1)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income from continuing operations before income taxes	9.0	4.4	7.6	3.7
Income taxes	3.6	1.6	3.0	1.4
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Income from continuing operations	5.4	2.8	4.6	2.3
Loss on discontinued operations	(1.8)	(0.1)	(4.3)	(1.0)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net income	3.6%	2.7%	0.3%	1.3%
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Charlotte Russe stores open at end of period	360	321	360	321
Rampage stores open at end of period	64	67	64	67



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**Three Months Ended June 24, 2006 Compared to the Three Months Ended June 25, 2005**

*Net Sales.* Our net sales from continuing operations increased to \$162.6 million from \$123.3 million, an increase of \$39.3 million, or 31.9%, over the same quarter last year. This increase reflects \$18.7 million of additional net sales from the seven new stores opened during the quarter ended June 24, 2006 as well as other stores opened in prior fiscal periods that did not qualify as comparable stores, and an 18.2% increase in comparable store sales, which resulted in increased sales of \$20.6 million compared to the same quarter in the prior fiscal year.

*Gross Profit.* Gross profit from continuing operations represents net sales less cost of goods sold, which includes buying, distribution and occupancy costs. Our gross profit increased to \$45.3 million from \$31.5 million, an increase of \$13.8 million, or 44.1%, from the same quarter last year. This increase was primarily the result of increased sales and higher gross profit margins. As a percentage of net sales, gross profit increased to 27.9% from 25.5%. The increase in gross profit as a percentage of net sales was principally due to a decrease in store occupancy costs, partially offset by a decrease in the initial markup for product sold.

*Selling, General and Administrative Expenses.* Our selling, general and administrative expenses from continuing operations increased to \$31.3 million from \$26.2 million, an increase of \$5.1 million, or 19.4%, over the same quarter last year. This increase was attributable to new store expansion and increased corporate expenses, specifically stock option and bonus expenses, professional fees and other operating expenses. As a percentage of net sales, selling, general and administrative expenses decreased to 19.3% from 21.2%, primarily due to the leveraging of store operating expenses and corporate expenses, partially offset by an increase in certain corporate expenses such as stock-based compensation and management bonus program expenses.

*Income Taxes.* Our effective tax rate of 39.7% approximates our statutory income tax rate. It was higher than the 35.3% tax rate utilized during the same quarter last year as we adjusted our tax liabilities in fiscal 2005 to reflect the reassessment of tax contingency balances.

*Income from Continuing Operations.* Our income from continuing operations increased to \$8.8 million from \$3.5 million, an increase of \$5.3 million, or 153.0%, from the same quarter last year. This increase was primarily due to an increase in gross profit which was partially offset by an increase in selling, general and administrative expenses.

*Loss on Discontinued Operations.* For stores meeting the criteria to be classified as discontinued operations, the net loss on an after-tax basis increased to \$3.0 million from \$0.2 million, an increase of \$2.8 million over the same quarter last year. The increase was principally due to higher store operating losses as our efforts to reposition the Rampage stores proved unsuccessful, and the accrual of a contract cancellation fee.

**Nine Months Ended June 24, 2006 Compared to the Nine Months Ended June 25, 2005**

*Net Sales.* Our net sales from continuing operations increased to \$498.3 million from \$362.2 million, an increase of \$136.1 million, or 37.6%, over the same period last year. This increase reflects \$73.9 million of additional net sales from the 21 new stores opened during the nine months ended June 24, 2006 as well as other stores opened in prior fiscal periods that did not qualify as comparable stores, and a 18.4% increase in comparable store sales, which resulted in increased sales of \$62.2 million compared to the same period in the prior fiscal year. Our net sales included an increase resulting from an adjustment of \$2.6 million to gift card liabilities for estimated unredeemed amounts for which no comparable amount was included in the same period of the prior year.

*Gross Profit.* Our gross profit from continuing operations increased to \$133.2 million from \$91.1 million, an increase of \$42.1 million, or 46.2%, from the same period last year. This increase was primarily the result of increased sales and higher gross profit margins. As a percentage of net sales, gross profit increased to 26.7% from 25.2%. The increase in gross profit as a percentage of net sales was principally due to a decrease in store occupancy costs, partially offset by an increase in markdowns and a decrease in the initial markup for product sold.

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*Selling, General and Administrative Expenses.* Our selling, general and administrative expenses from continuing operations increased to \$96.7 million from \$78.2 million, an increase of \$18.5 million, or 23.7%, over the same period last year. This increase was attributable to new store expansion and increased corporate expenses, specifically stock option and bonus expenses, professional fees and other operating expenses. As a percentage of net sales, selling, general and administrative expenses decreased to 19.4% from 21.6%, primarily due to the leveraging of store operating expenses, partially offset by an increase in certain corporate expenses such as stock-based compensation expense and management bonus program expenses.

*Income Taxes.* Our effective tax rate of 39.7% approximates our statutory income tax rate. It was higher than the 37.5% tax rate utilized during the same period last year as we adjusted our tax liabilities in fiscal 2005 to reflect the reassessment of tax contingency balances.

*Income from Continuing Operations.* Our income from continuing operations increased to \$22.9 million from \$8.3 million, an increase of \$14.6 million, or 175.8%, from the same period last year. This increase was primarily due to an increase in gross profit which was partially offset by an increase in selling, general and administrative expenses.

*Loss on Discontinued Operations.* For stores meeting the criteria to be reclassified as discontinued operations, the net loss on an after-tax basis increased to \$21.5 million from \$3.6 million, an increase of \$17.9 million over the same period last year. The increase was principally due to the \$13.6 million after-tax impairment charge recorded in the second quarter, higher store operating losses as our efforts to reposition the Rampage stores proved unsuccessful, and the accrual of a contract cancellation fee.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our working capital requirements vary consistent with the seasonality of our business. Our capital requirements result primarily from capital expenditures related to new store openings. We have historically satisfied our cash requirements principally through cash flow from operations, although in some prior years we have also used borrowings under prior credit facilities for acquisitions, including our acquisition and the acquisition of the Rampage stores. Due to the rapid turnover of our inventory, we generate trade payables and other accrued liabilities sufficient to offset most of our working capital requirements, and this allows us to generally operate with limited working capital. As of June 24, 2006, we had working capital of approximately \$75.9 million which included cash and cash equivalents of \$65.5 million and deferred tax assets of \$15.7 million.

Our net cash provided by operating activities of continuing operations was \$49.3 million and \$31.7 million for the nine months ended June 24, 2006 and June 25, 2005, respectively. This increase of \$17.6 million was due to higher operating income from our store operations partially offset by an increased investment in our working capital accounts. Our net cash used in investing activities of continuing operations was \$22.0 million and \$29.2 million for the nine months ended June 24, 2006 and June 25, 2005, respectively. The primary component of investing activities during both nine month periods was purchases of fixed assets, which consisted primarily of new store openings and other corporate expenditures.

In the nine months ended June 24, 2006 and June 25, 2005, we opened 21 and 28 new stores, respectively. During fiscal 2006, we plan to open 41 new Charlotte Russe stores compared to 49 new store openings in fiscal 2005. After taking into account new store construction, existing store remodeling, distribution center expenditures, and other corporate capital projects, total capital expenditures for fiscal year 2006 are projected to range from approximately \$40.0 to \$44.0 million, of which \$22.0 million was spent during the nine months ended June 24, 2006.



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Our net cash provided by financing activities was \$5.2 million and \$0.4 million for the nine months ended June 24, 2006 and June 25, 2005, respectively. Net cash from financing activities primarily consists of the net proceeds of stock option exercises and related excess tax benefits.

We currently have a \$40.0 million secured revolving credit facility (the Credit Facility) with Bank of America, N.A., which expires on June 30, 2010. Under the terms of the Credit Facility, we may borrow up to the maximum borrowing limit of \$40.0 million less any outstanding letters of credit, and we have set the initial loan ceiling amount at \$30.0 million. Interest on the Credit Facility is payable quarterly, at our option, at either (i) the Bank's prime rate plus 0.50% to 1.00% (Base Rate), or (ii) 1.00% to 1.50% over the average interest settlement rate for deposits in the London interbank market banks (Eurodollar Rate) subject to certain adjustments. Our ability to receive loan advances under the Credit Facility is subject to our continued compliance with various covenants, representations and warranties, and conditions, including but not limited to negative covenants against the incurrence of debt or liens. The Credit Facility also contains events of default customary for facilities of this type and provides that, upon the occurrence of an event of default, payment of all outstanding loans may be accelerated and/or the lenders' commitments may be terminated. Pursuant to this agreement, we and our wholly-owned subsidiaries have (i) provided an unconditional guarantee of the full and punctual payment of obligations under the Credit Facility, (ii) pledged certain of our securities to the collateral agent as security for the full payment and performance of our obligations under the Credit Facility and (iii) granted a security interest in essentially all of our personal property as security for the full payment and performance of our obligations under the Credit Facility. At June 24, 2006, there was no outstanding debt under the Credit Facility and we were in compliance with the terms of the bank credit agreement. As of June 24, 2006, we had \$25.3 million of borrowing availability under the Credit Facility.

We believe that our cash flows from operations, our current cash balance and the funds available under our Credit Facility will be sufficient to meet our working capital needs and contemplated capital expenditure requirements through fiscal 2006. If our cash flow from operations should decline significantly, it may be necessary for us to seek additional sources of capital or to reduce planned new store openings.

**LETTERS OF CREDIT**

Pursuant to the terms of the Credit Facility, we can issue up to \$20.0 million of documentary or standby letters of credit. The outstanding commitments under the Credit Facility at June 24, 2006 totaled approximately \$4.7 million, including \$2.2 million in standby letters of credit.

**CONTRACTUAL OBLIGATIONS**

Our commitment to make future payments under long-term contractual obligations was as follows, as of June 24, 2006:

	Total	Less Than 1 Year	1-3 Years	3-5 Years	After 5 Years
<b>Contractual Obligations:</b>					
			(in thousands)		
Operating leases	\$ 448,729	\$ 66,564	\$ 130,067	\$ 116,299	\$ 135,799
Other long-term obligations	1,875	1,875			
	<u>\$ 450,604</u>	<u>\$ 68,439</u>	<u>\$ 130,067</u>	<u>\$ 116,299</u>	<u>\$ 135,799</u>



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**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, as well as revenues and expenses during the reported periods.

On an on-going basis, management evaluates its estimates and judgments regarding inventories, receivables, fixed assets, intangible assets, accrued liabilities, income taxes and contingencies and litigation. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. The results from this evaluation form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Under different assumptions or conditions, alternative estimates and judgments could be derived which would differ from the estimates being used by management. Actual results could differ from any or all of these estimates.

As a retailer of women's apparel and accessories, our financial statements are affected by several critical accounting policies, many of which affect management's use of estimates and judgments, as described in the Notes to our Consolidated Financial Statements included elsewhere in this Quarterly Report on Form 10-Q. We sell merchandise directly to retail customers and recognize revenue at the point of sale. Customers have the right to return merchandise to us, and we maintain a reserve for the financial impact of returns which occur subsequent to the current reporting period.

We estimate the fair value of stock options granted using the Black-Scholes option-pricing formula and a multiple option award approach. This fair value is then amortized over the requisite service periods of the awards. This option-pricing model requires the input of highly subjective assumptions, including the option's expected life, price volatility of the underlying stock, risk free interest rate and expected dividend rate. As stock-based compensation expense is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

Our policy with respect to gift cards is to record revenue as the gift cards are redeemed for merchandise. Prior to their redemption, unredeemed gift cards are recorded as a liability, included within accrued expenses and other current liabilities. Beginning with the second quarter of fiscal 2006, we adjust the gift card liability balances on a quarterly basis to recognize estimated unredeemed amounts under the redemptive recognition method. This method records gift card breakage as additional sales on a proportional basis over the redemption period based on historical redemption trends. Such adjustments are included in net sales and operating income.

Our merchandise is initially offered for sale at a regular price, but is often marked down prior to the ultimate sale of all such units. We utilize the retail method of accounting for our inventory valuation that inherently reduces the inventories' carrying value as permanent markdowns are initiated. In addition, we maintain a reserve for the financial impact of markdowns that we believe are likely to be encountered in the future. If actual demand or market conditions are more or less favorable than those projected by management, the level of the reserve for future markdowns would be subject to change in subsequent reporting periods.

We also provide for estimated inventory losses for damaged, lost or stolen inventory for the period from the last physical inventory to the financial statement date. These estimates are based on historical experience and other factors.

We receive certain allowances from our vendors primarily related to distribution center handling expenses or defective merchandise. These allowances are reflected as a reduction of merchandise inventory in the period they are received and allocated to cost of sales during the period in which the items were sold.



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We have recorded a goodwill asset that arose from the acquisition of our business in September 1996. This asset is tested for possible impairment on at least an annual basis in accordance with SFAS No. 142, *Goodwill and Other Intangibles*. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, we assess the impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors considered important that could trigger an impairment review include a significant underperformance relative to historical or projected future operating results, a significant change in the manner of the use of the asset or a significant negative industry or economic trend. Upon determining that the carrying value of long-lived assets may not be recoverable based upon the existence of one or more of the above indicators of impairment, we estimate the future cash flows expected to result from the use of the assets.

Based upon a review of the carrying value of the long-lived assets of the Rampage stores compared with the estimated future discounted and non-discounted cash flows from the operations of the Rampage stores, we recorded a non-cash impairment charge of \$22.5 million as of the end of the second quarter of fiscal 2006. This resulted from our unsuccessful efforts to reposition the 64 Rampage stores and significant deterioration in results during the second quarter of fiscal 2006. This charge represented a write down of substantially all of the carrying value of Rampage long-lived assets at the end of the second quarter.

During the third quarter of fiscal 2006 management completed an evaluation of the strategic alternatives for the Rampage stores. That review culminated in an announcement on June 29, 2006 that we had entered into an agreement to sell the leasehold interests, store fixtures and equipment for 44 Rampage store locations. We will receive approximately \$14 million of sales proceeds from this all-cash transaction, subject to and contingent upon the satisfaction of certain conditions including receipt of landlord consents with respect to each store. This sale transaction is expected to be reported in the fourth quarter of fiscal 2006 which began on June 25, 2006. Of the 20 Rampage stores not included in this transaction, we intend to convert approximately four stores into Charlotte Russe locations and to sell or abandon the remaining Rampage stores within the next 12 months.

We record rent expense on noncancellable leases containing known future scheduled rent increases on a straight-line basis over the respective leases beginning when we receive possession of the leased property for construction purposes. The difference between rent expense and rent paid is accounted for as deferred rent. Landlord construction allowances and other such lease incentives are recorded as deferred lease credits, and are amortized on a straight-line basis over the life of the lease as a reduction to rent expense.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In October 2005, the FASB issued FASB Staff Position Financial Accounting Standard ( FSP FAS ) 13-1, *Accounting for Rental Costs Incurred during Construction Period*. FSP FAS 13-1 clarifies the accounting for rental costs associated with operating leases that are incurred during a construction period. In addition, FSP FAS 13-1 requires that a lessee shall cease capitalizing rental costs as of the effective date of FSP FAS 13-1 for operating lease arrangements entered into prior to the effective date of FSP FAS 13-1. FSP FAS 13-1 is effective for periods beginning after December 15, 2005. The adoption of FSP FAS 13-1 did not have a material impact on our operating results or financial condition.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our market risks relate primarily to changes in interest rates. We bear this risk in two specific ways. First, the Credit Facility carries a variable interest rate that is tied to market indices and, therefore, our statement of income and our cash flows are exposed to changes in interest rates. As of June 24, 2006, we had no borrowings against our Credit Facility. However, we may borrow funds under our Credit Facility as needed.



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The second component of interest rate risk involves the short-term investment of excess cash in short-term, investment-grade interest-bearing securities. These investments are considered to be cash equivalents and are shown that way on our balance sheet. If there are changes in interest rates, those changes would affect the investment income we earn on these investments and, therefore, impact our cash flows and results of operations.

We believe our market risk exposure is immaterial.

### **ITEM 4. CONTROLS AND PROCEDURES**

Based upon an evaluation, under the supervision and with the participation of our Disclosure Committee and management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Securities Exchange Act of 1934 Rules 13a-15(b) and 15d-15(b), the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the fiscal quarter ended June 24, 2006, our disclosure controls and procedures are effective.

### **Changes in Internal Control Over Financial Reporting**

There were no changes in our internal controls during the fiscal quarter ended June 24, 2006 that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

On December 14, 2004, plaintiff David Phillips, on behalf of himself and purportedly on behalf of a class of others similarly situated, filed a complaint seeking damages in the United States District Court for the Southern District of California against us and two of our officers, alleging violations of federal securities laws related to declines in our stock price in connection with various statements and alleged omissions to the public and to the securities markets. Two follow-on actions were filed in the same court alleging substantially similar claims, and on April 25, 2005, all these claims were consolidated into a single action. On October 31, 2005, we reached an agreement in principle (subject to final court approval) to settle the securities litigation pending against us and certain of our officers and directors for the sum of \$3.9 million, paid mostly by our insurance carrier. In the fourth quarter of fiscal 2005, we incurred a pre-tax charge of approximately \$600,000 associated with defense and settlement costs. On March 14, 2006, the court entered an order granting preliminary approval of the settlement. A final settlement hearing was held on June 8, 2006. The court took the matter under submission and stated that it would rule after the filing of an additional document by plaintiffs.

In addition to the foregoing, from time to time, we may be involved in litigation relating to claims arising out of our operations. As of the date of this filing, we are not engaged in any legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or results of operations.



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**ITEM 1A. RISK FACTORS**

**RISKS RELATING TO OUR BUSINESS**

*Our success depends on our ability to identify and rapidly respond to consumer fashion tastes.*

The fashion retail industry is subject to rapidly evolving fashion trends and shifting consumer demands. Accordingly, our success is heavily dependent both on the priority our target customers place on fashion and on our ability to anticipate, identify and capitalize upon emerging fashion trends in a timely manner. Current fashion tastes place significant emphasis on a fashionable look. In the past this emphasis has increased and decreased through fashion cycles and decreased emphasis has adversely affected our results. If we do not anticipate, identify or react appropriately and timely to changes in styles, trends, desired images or brand preferences, it may lead to, among other things, excess inventories and higher markdowns, as well as decreased appeal of our Charlotte Russe brand.

*We intend to continue to open new stores, which could strain our resources and cause us to operate our business less effectively.*

Our growth will largely depend on successfully opening and operating new stores. During fiscal 2005, we opened 49 new stores and closed 1 Rampage store representing a 13% net increase from the number of stores open at the end of fiscal 2004. During the nine months ended June 24, 2006, we opened 21 new stores, closed 5 stores, and we plan to open 41 new Charlotte Russe stores during fiscal 2006, an increase of 12% from the number of Charlotte Russe stores open as of September 24, 2005. We intend to continue to increase our number of Charlotte Russe stores for at least the next several years.

In order to support our planned expansion we will need to continually monitor and upgrade our management information and other systems. This expansion also will place increased demand on our managerial, operational, and administrative resources. These increased demands and operating complexities could cause us to operate our business less effectively, which in turn could cause deterioration in the financial performance of our individual stores and slow our new store growth.

*Our planned expansion involves a number of risks that could prevent or delay the successful opening of new stores as well as impact the performance of our existing stores.*

Our ability to open and operate new stores successfully depends on many factors, including, among others, our ability to:

identify suitable store locations, the availability of which is outside of our control;

negotiate acceptable lease terms, including desired tenant improvement allowances;

source sufficient levels of inventory to meet the needs of new stores;

hire, train and retain store personnel;

successfully integrate new stores into our existing operations; and

identify and satisfy the fashion preferences of new geographic areas.

In addition, some of our new stores will be opened in regions of the United States in which we currently have few or no stores. The expansion into new markets may present competitive, merchandising and distribution challenges that are different from those currently encountered in our existing markets. Any of these challenges could adversely affect our business and results of operations. In addition, to the extent our new store openings are in existing markets, we may experience reduced net sales volumes in existing stores in those markets.

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### ***Our plans to dispose of the Rampage stores contains various risks.***

We may not be able to satisfy the conditions which are required in order for us to receive all of the sales proceeds from our recent sale of the leasehold interests, store fixtures and equipment for 44 Rampage store locations that were sold. In addition, we may also incur continued operating losses with respect to those stores and possibly disposition costs, both of which could adversely impact our future results.

### ***A decline in general economic conditions may lead to reduced consumer demand for our apparel and accessories.***

Consumer spending habits, including spending for the fashionable apparel and related accessories that we sell, are affected by, among other things, prevailing economic conditions, levels of employment, salaries and wage rates, consumer confidence, consumer perception of economic conditions and potential impact of higher gasoline prices on consumer spending. A general slowdown in the United States economy and an uncertain economic outlook could adversely affect consumer spending habits and mall traffic, which could result in lower net sales than expected and could cause us to slow our expansion plans.

### ***Our stores are heavily dependent on the customer traffic generated by shopping malls.***

Most of our store locations are not sufficiently concentrated to make significant marketing expenditures cost effective. As a result, we depend heavily on locating our stores in prominent locations within successful shopping malls in order to generate customer traffic. We cannot control the development of new shopping malls, the availability or cost of appropriate locations within existing or new shopping malls or the success of individual shopping malls.

### ***Our market share may be adversely impacted at any time by a significant number of competitors.***

We operate in a highly competitive environment characterized by low barriers to entry. We compete against a diverse group of retailers, including national and local specialty retail stores, regional retail chains, traditional department stores and, to a lesser extent, mass merchandisers. Our market share and results of operations may be adversely impacted by this significant number of competitors. Many of our competitors also are larger and have substantially greater resources than we do.

### ***We rely on our good relationships with vendors to implement our business strategy successfully.***

Our business is dependent on continued good relations with our vendors. In particular, we believe that we generally are able to obtain attractive pricing and other terms from vendors because we are perceived as a desirable customer. Our merchandise strategy also relies in large part on our ability to obtain much of our merchandise from our vendors within three to six weeks from the date of order. Our failure to maintain good relations with our vendors could increase our exposure to changing fashion cycles, which may in turn lead to increased inventory markdown rates.

*Certain members of our senior management team have limited tenure with us.*

Our business requires disciplined execution at all levels of our organization in order to timely deliver and display fashionable merchandise in appropriate quantities in our stores. This execution requires experienced and talented management. If we fail to attract, motivate and retain qualified and talented key personnel, it may adversely affect our business and inhibit our plans for future growth.

During the past year, we hired a Senior Vice President for Charlotte Russe Apparel, a Vice President of Stores, and a Senior Vice President for Real Estate and Construction. Although these individuals have significant experience in these and similar roles with other apparel retailers, they have limited tenure with our company.



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*If at any time our comparable store sales and quarterly results of operations decline or do not meet the expectations of research analysts, the price of our common stock could decline substantially.*

Our quarterly results of operations for our individual stores have fluctuated in the past and can be expected to continue to fluctuate in the future. For instance, our quarterly comparable store sales percentages for the Charlotte Russe stores have ranged as high as positive 21.0% and as low as negative 6.6% over the past two years. Our net sales and operating results are typically lower in the second quarter of our fiscal year due to the traditional retail slowdown immediately following the winter holiday season. Our comparable store sales and quarterly results of operations are affected by a variety of factors, including:

the timing of new store openings and the relative proportion of new stores to mature stores;

fashion trends;

calendar shifts of holiday or seasonal periods;

the effectiveness of our test-and-reorder strategy in maintaining appropriate inventory levels;

changes in our merchandise mix;

timing of promotional events;

general economic conditions and, in particular, the retail sales environment;

actions by competitors or mall anchor tenants;

weather conditions; and

the level of pre-opening expenses associated with new stores.

*The failure to efficiently complete the planned replacement of certain of our technology and information systems could negatively impact our business.*

The efficient operation of our business is heavily dependent on information systems. In particular, we rely upon technology and information systems for inventory control and other critical information. We periodically review, improve and, under certain circumstances, replace information systems to provide enhanced support to all operating areas. If such upgrades and enhancements are not successfully implemented, then the current systems may not be able to continue to adequately support our information requirements.

*Our operations, as well as a substantial number of our stores, are concentrated in the Southwest and other heavily populated regional areas, which makes us susceptible to adverse conditions in these regions.*

Our headquarters and distribution centers are located in California, and a substantial number of our stores are located in California, Florida and Texas. As a result, our business may be more susceptible to regional factors than the operations of more geographically diversified competitors. These factors include, among others, economic and weather conditions, demographic and population changes, and fashion tastes. Further, a natural disaster or other catastrophic event, such as an earthquake affecting southern California, or hurricanes affecting the Southeastern states and Texas, could significantly disrupt our operations.

*The loss of, or disruption of operations in, either of our two distribution centers could negatively impact our business.*

Our merchandise is distributed through two modern facilities that use automated systems for sorting apparel and shipping merchandise. We depend on the orderly operation of our facilities and distribution processes, as well as sufficient shipping resources. Disruptions in these operations due to fire, earthquake or other catastrophic events, employee matters (including work stoppages), shipping problems or other events could result in delays in the delivery of merchandise to our stores.

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### *The effects of war or acts of terrorism could adversely affect our business.*

The continued threat of terrorism, heightened security measures and military action in response to an act of terrorism has disrupted commerce and has intensified the uncertainty of the United States economy. Any further acts of terrorism, particularly directed at malls, or new or extended hostilities may disrupt commerce and undermine consumer confidence, which could negatively impact our sales by causing mall traffic or consumer spending to decline.

### *Our business could be adversely impacted by unfavorable international conditions.*

We receive apparel and other merchandise from foreign sources, both purchased directly in foreign markets and indirectly through domestic vendors with foreign sources. To the extent that any of our vendors are located overseas or rely on overseas sources for a large portion of their products, any event causing a disruption of imports, including the imposition of import restrictions, could harm our ability to source product. This disruption could materially limit the merchandise that we would have available for sale and reduce our revenues and earnings. The flow of merchandise from our vendors could also be adversely affected by financial or political instability, or war, in or affecting any of the countries in which the goods we purchase are manufactured or through which they flow. Trade restrictions in the form of tariffs or quotas, or both, that are applicable to the products that we sell also could affect the import of those products and could increase the cost and reduce the supply of products available to us. Any material increase in tariff levels, or any material decrease in quota levels or available quota allocation, could negatively impact our business. Further, changes in tariffs or quotas for merchandise imported from individual foreign countries could lead us to shift our sources of supply among various countries. Any such shift we undertake in the future could result in a disruption of our sources of supply and lead to a reduction in our revenues and earnings. Supply chain security initiatives undertaken by the U.S. government that impede the normal flow of product could also negatively impact our business.

## **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

### **Dividends**

We have never declared nor paid dividends on our common stock and we do not intend to pay any dividends on our common stock in the foreseeable future. We currently intend to retain earnings to finance future operations and expansion. Moreover, under the terms of the Credit Facility, stock dividends and distributions are restricted.

## **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

## **ITEM 4. SUBMISSIONS OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

**ITEM 5. OTHER INFORMATION**

Not applicable.

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**ITEM 6. EXHIBITS**

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer 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, as amended, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of San Diego, State of California, on the 28<sup>th</sup> day of July, 2006.

CHARLOTTE RUSSE HOLDING, INC.

By:                     /s/ DANIEL T. CARTER

**Daniel T. Carter**

**Executive Vice President and**

**Chief Financial Officer**