1 800 CONTACTS INC
Form 10-Q
November 13, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

(Mark one)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 29, 2001

[_] 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	87-0571643
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
66 E. Wadsworth Park Drive, 3/rd/ Floor Draper, UT	84020
(Address of principal executive offices)	(Zip Code)

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

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.

[X] Yes No [_]

As of November 6, 2001, the Registrant had 11,574,269 shares of Common Stock, par value $0.01 per share outstanding.

1-800 CONTACTS, INC.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

ASSETS

	December 30, 2000	Se
CURRENT ASSETS:		
Cash and cash equivalents	$ 42,558	
Inventories	20,402,076	
Deferred income taxes	673,710	
Other current assets	385,001	
Total current assets	21,503,345	
PROPERTY AND EQUIPMENT, net	2,843,103	
DEFERRED INCOME TAXES	203,620	
INTANGIBLE ASSETS, net	1,261,916	

OTHER ASSETS	295,775
Total assets	$ 26,107,759

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES:	
Line of credit	$ 3,264,979
Accounts payable	3,646,578
Accrued liabilities	3,541,463
Income taxes payable	1,206,523
Unearned revenue	483,812
Total current liabilities	12,143,355
STOCKHOLDERS' EQUITY:	
Common stock	128,611
Additional paid-in capital	23,802,342
Retained earnings	8,412,507
Treasury stock at cost	(18,376,111)
Accumulated other comprehensive loss	(2,945)
Total stockholders' equity	13,964,404
Total liabilities and stockholders' equity	$ 26,107,759

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Quarter Ended		Th
	September 30, 2000	September 29, 2001	Septemb 20
NET SALES	$40,724,366	$44,374,981	$ 10
COST OF GOODS SOLD	24,365,987	26,867,856	6
Gross profit	16,358,379	17,507,125	4
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES:			
Advertising expense	7,947,936	7,786,504	2
Legal and professional fees	152,534	1,037,743	

Other selling, general and administrative expenses	4,036,859	5,289,486	1
Total selling, general and administrative expenses	12,137,329	14,113,733	3
INCOME FROM OPERATIONS	4,221,050	3,393,392	1
OTHER INCOME (EXPENSE), net	26,475	(35,904)	
INCOME BEFORE PROVISION FOR INCOME TAXES	4,247,525	3,357,488	1
PROVISION FOR INCOME TAXES	(1,660,363)	(1,299,709)	(
NET INCOME	$ 2,587,162	$ 2,057,779	$
PER SHARE INFORMATION:			
Basic net income per common share	$ 0.22	$ 0.18	$
Diluted net income per common share	$ 0.22	$ 0.18	$

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
For the Three Quarters Ended September 29, 2001
(Unaudited)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Treasu
	Shares	Amount			Shares
BALANCE, December 30, 2000	12,861,136	$ 128,611	$ 23,802,342	$ 8,412,507	(1,289,555)
Purchase of treasury shares	-	-	-	-	(22,500)
Exercise of common stock options	-	-	14,692	-	22,775
Income tax benefit from common stock options exercised	-	-	150,770	-	-
Net income	-	-	-	7,710,520	-
Foreign currency translation adjustments	-	-	-	-	-

Comprehensive income					
BALANCE, September 29, 2001	12,861,136	$ 128,611	$ 23,967,804	$16,123,027	(1,289,280)

	Total Stockholders' Equity	Comprehensive Income
BALANCE, December 30, 2000	$ 13,964,404	
Purchase of treasury shares	(438,125)	
Exercise of common stock options	152,752	
Income tax benefit from common stock options exercised	150,770	
Net income	7,710,520	$ 7,710,520
Foreign currency translation adjustments	161	161
Comprehensive income		$ 7,710,681
BALANCE, September 29, 2001	$ 21,540,482	

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

1-800 CONTACTS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Qua
	September 30, 2000
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net income	$ 7,429,47
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	821,37

Gain on sale of property and equipment	(2,65
Loss on impairment of non-marketable securities	
Deferred income taxes	(360,35
Changes in operating assets and liabilities:	
Inventories	(4,027,32
Other current assets	(764,65
Accounts payable	5,193,85
Accrued liabilities	1,567,63
Income taxes payable	1,131,47
Unearned revenue	211,23
Net cash provided by operating activities	11,200,04
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchase of property and equipment	(880,26
Proceeds from sale of property and equipment	2,65
Purchase of intangible assets	(10,00
Purchase of non-marketable securities	(220,00
Deposits	5,30
Net cash used in investing activities	(1,102,30
CASH FLOWS FROM FINANCING ACTIVITIES:	
Common stock repurchases	(16,841,44
Proceeds from exercise of common stock options	419,44
Net borrowings (repayments) on line of credit	2,468,54
Principal payments on capital lease obligation	(30,16
Payment of acquisition payable	(300,00
Net cash used in financing activities	(14,283,62
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(4,185,88
EFFECT OF FOREIGN EXCHANGE RATES ON CASH	
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	4,329,08
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 143,20
SUPPLEMENTAL CASH FLOW INFORMATION:	
Cash paid for interest	$ 1,99
Cash paid for income taxes	4,435,98

The accompanying notes to condensed consolidated financial statements are an integral part of these condensed consolidated statements.

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1-800 CONTACTS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. PRESENTATION OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The accompanying condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments), which in the opinion of management, are necessary to present fairly the results of operations of the Company for the periods presented. It is suggested that these condensed consolidated financial statements be read in conjunction with the audited financial statements and the notes thereto included in the Company's Annual Report to Shareholders on Form 10-K.

The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.

NOTE 2. NET INCOME PER COMMON SHARE

Basic net income per common share ("Basic EPS") excludes dilution and is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per common share ("Diluted EPS") reflects the potential dilution that could occur if stock options or other common stock equivalents were exercised or converted into common stock. The computation of Diluted EPS does not assume exercise or conversion of securities that would have an antidilutive effect on net income per common share. For the quarter ended September 29, 2001, options to purchase 168,434 shares of common stock were not included in the computation of Diluted EPS because the exercise prices of the options were greater than the average market price of the common shares.

The following is a reconciliation of the numerator and denominator used to calculate Basic and Diluted EPS:

	Quarter Ended September 30, 2000			Quarter Ended Septe	
	Net Income	Shares	Per-Share Amount	Net Income	Share
Basic EPS	$ 2,587,162	11,584,136	$ 0.22	$2,057,779	11,571,
Effect of stock options		290,471			149,
Diluted EPS	$ 2,587,162	11,874,607	$ 0.22	$2,057,779	11,721,

	Three Quarters Ended September 30, 2000			Three Quarters Ended Sept	
	Net Income	Shares	Per-Share Amount	Net Income	Share
Basic EPS	$ 7,429,473	11,969,867	$ 0.62	$7,710,520	11,574,
Effect of stock options		231,134			193,
Diluted EPS	$ 7,429,473	12,201,001	$ 0.61	$7,710,520	11,768,

NOTE 3. COMMON STOCK TRANSACTIONS

During the three quarters ended September 29, 2001, the Company repurchased 22,500 shares of its common stock for a total cost of $438,125.

On April 20, 2001, the Company's Board of Directors authorized an additional repurchase of up to 1,000,000 shares of its common stock, bringing the total authorization to 3,000,000 shares. A purchase of the full 3,000,000 shares would equal approximately 23.3 percent of the total shares issued. The repurchase of common stock is subject to market conditions and is accomplished through periodic purchases at prevailing prices on the open market, by block purchases or in privately negotiated transactions. The repurchased shares will be retained as treasury stock to be used for corporate purposes. Through September 29, 2001, the Company had repurchased 1,506,500 shares for a total cost of $19,891,234.

During the three quarters ended September 29, 2001, employees exercised stock options to purchase 22,775 shares of common stock for a total of $152,752.

During the three quarters ended September 29, 2001, the Company granted nonqualified stock options to purchase 111,564 shares of common stock to employees and directors of the Company. The exercise prices of the options range from $15.74 to $34.938. The options vest equally over a four year period and expire in ten years.

NOTE 4. IMPAIRMENT OF INVESTMENT

During the first quarter of fiscal 2001, the Company determined that its investment in the stock of an entity in which a member of the Company's Board of Directors holds a significant ownership interest and serves as an officer and director was impaired. The Company recorded a $220,000 loss to adjust the investment to its determined net realizable value of $0.

NOTE 5. LINE OF CREDIT

The Company has a revolving credit facility that provides for borrowings equal to the lesser of $20.0 million or 50 percent of eligible inventory. The credit facility bears interest at a floating rate equal to the lender's prime interest rate minus 0.25 percent (5.75 percent as of September 29, 2001). As of September 29, 2001, the Company had no outstanding borrowings on the credit facility. The credit facility is secured by substantially all of the Company's assets and contains financial covenants customary for this type of financing. The credit facility expires April 30, 2003.

NOTE 6. LEGAL MATTERS

On July 14, 1998, Craig S. Steinberg, O.D., a professional corporation d.b.a. City Eyes Optometry Center, filed a purported class action on behalf of all California optometrists against the Company and its directors in Los Angeles County Superior Court. In a series of rulings in late 2000 and early 2001, the trial court struck all of Steinberg's claims for monetary relief and another claim was dismissed. After Steinberg's appeals to the California Court of Appeals and California Supreme Court were denied, the parties settled the action in April 2001. The settlement did not materially impact the Company's results of operations.

On April 7, 1999, the Kansas Board of Examiners in Optometry ("KBEO") commenced a civil action against the Company. The action was filed in the District Court of Shawnee County, Kansas, Division 6. The complaint was amended on May 28, 1999. The amended complaint alleges that "on one or more occasions" the Company sold contact lenses in the state of Kansas without receipt of a prescription. The amended complaint seeks an order enjoining the Company from further engaging in the alleged activity. The amended complaint does not seek monetary damages. In response to the amended complaint, the Company has retained counsel, and intends to vigorously defend itself in this action. The Company has filed an answer to the amended complaint and, at the request of the Court, filed a motion for summary judgment. In November 2000, the Court issued an order denying the summary judgment motion, finding that there were factual issues regarding whether the KBEO can meet the

requirements necessary to obtain injunctive relief, and whether the Kansas law violates the Commerce Clause of the United States Constitution. The parties are now engaging in fact and expert discovery in preparation for trial.

On or about November 2, 1999, the Texas Optometry Board ("TOB") filed a civil action against the Company seeking injunctive relief and civil penalties against the Company for alleged violations of the Texas Optometry Act. The TOB alleges that the Company (1) failed to state explicitly in its advertisements that a written prescription is required to purchase contact lenses in Texas and (2) dispensed contact lenses without such a prescription. The Company has filed an answer and plans to vigorously defend this action. The Company also has filed a counterclaim against the TOB seeking to (1) require the TOB to enforce the Texas Optometry Act and the Contact Lens Prescription Act against optometrists who have violated these laws, (2) prevent the TOB from conducting proceedings regarding the dispensing of contact lenses in which the members of the TOB have a substantial pecuniary interest; and (3) challenge the constitutionality of the Texas Optometry Act, the Contact Lens Prescription Act, and various TOB administrative rules. Currently, the TOB is revising its administrative rules, which may resolve some of the issues in dispute. The Company also is engaged in discussions with the TOB regarding this action.

The Company entered into a written settlement agreement with the Texas Department of Health ("TDH"), the regulatory authority in Texas for sellers of contact lenses. This settlement agreement became effective on February 29, 2000, and relates to the Company's sales practices in Texas. The agreement began to be implemented in November 2000 and allows for a review of and, if necessary, changes to the Company's practices during an initial six-month period. The TDH issued a Notice of Violation against the Company on or about February 26, 2001, alleging that the Company failed to comply with certain provisions of the agreement. The Company is engaged in discussions with the TDH regarding this notice.

On May 22, 2001, the Middle District Court in Jacksonville, Florida announced a preliminary settlement with Johnson & Johnson with respect to the multi-district litigation ("MDL") brought by the attorneys general of 32 states on behalf of a nationwide class of consumers. This suit alleged that consumers overpaid for contact lenses as a result of antitrust violations by Johnson & Johnson, CIBA Vision, Bausch & Lomb, and the American Optometric Association ("AOA"). Specifically, the attorneys general alleged that the manufacturers and the AOA conspired to eliminate competition from alternative distribution channels, including mail order companies, and ensure that contact lenses would only be available from eye care professionals. On or about October 12, 2001 the Company was granted intervener status by the court in the MDL 1030 lawsuit. This status allows the Company to become a party to the lawsuit for the limited purpose of enforcing the injunctive relief provisions of the MDL settlement agreement, e.g. requiring Johnson and Johnson - Vistakon ("Vistakon") to sell its products directly to the Company. The court finalized the MDL settlement agreement on November 1, 2001. The agreement will be effective on December 1, 2001 provided there are no appeals to the settlement agreement.

On October 18, 2001, Vistakon filed an action against the Company concerning certain of its communications with customers informing them of the Company's belief that there are superior products available from other manufacturers with less restrictive distribution policies. The action was filed in the Middle District Court in Jacksonville, Florida. The complaint alleges claims for false advertising, unfair trade practices, tortious interference with prospective economic advantage and defamation and seeks both damages and injunctive relief. Vistakon also filed a motion for preliminary injunction which the Company opposed. The court heard the matter on November 7, 2001 but has not yet issued a ruling. The Company believes the complaint lacks merit and plans to vigorously defend the action.

From time to time the Company is involved in other legal matters generally incidental to its business.

It is the opinion of management, after discussion with legal counsel, that the ultimate dispositions of all of these matters will not likely have a material impact on the financial condition, liquidity or results of operations of the Company. However, there can be no assurance that the Company will be successful in its efforts to satisfactorily resolve these matters and the ultimate outcome could result in a material negative impact on the Company's results of operations and financial position.

NOTE 7. RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, "Business Combinations," and No. 142, "Goodwill and Other Intangible Assets," effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of fiscal 2002. Also during fiscal 2002, the Company will perform the first of the required impairment tests of goodwill and indefinite lived intangible assets, to the extent applicable. The Company has not yet determined what the effect of these Statements will be on the Company's results of operations and financial position.

NOTE 8. SOURCES OF SUPPLY

On May 22, 2001, the Middle District Court in Jacksonville, Florida announced a preliminary settlement with Johnson & Johnson with respect to the multi-district litigation brought by the attorneys general of 32 states on behalf of a nationwide class of consumers. The court finalized the settlement agreement on November 1, 2001. The agreement will be effective on December 1, 2001 provided there are no appeals to the settlement agreement. Johnson & Johnson's current interpretation of the settlement agreement, and its subsequent actions, have made products produced by its eye care division, Vistakon, more difficult for the Company to obtain. This restricted supply and the resulting wholesale price increases have reduced the Company's expectations for its short-term net sales and gross profit. During the third quarter of fiscal 2001, gross profit was impacted by the increase in wholesale prices paid for Vistakon products. At the beginning of the third quarter of fiscal 2001, the Company had approximately a three to four month supply of Vistakon lenses; therefore, the impact of the increase in wholesale prices was less significant in the third quarter. Gross profit in the fourth quarter of fiscal 2001 will be more significantly impacted by this increase in wholesale prices. The Company's wholesale prices on Vistakon products have continued to increase substantially and Vistakon products account for more than 40% of the Company's net sales. If supply of Vistakon products remains limited and wholesale prices remain higher than expected, gross profit will continue to be impacted significantly in future quarters.

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

Overview

The Company is a leading direct marketer of replacement contact lenses. The Company was formed in February 1995 and is the successor to the mail order business founded by the Company's Vice President of Sales in March 1991. Since its formation, the Company's net sales have grown rapidly, from $3.6 million in fiscal 1996 to $145.0 million in fiscal 2000 and from $107.9 million in the first three quarters of fiscal 2000 to $131.4 million in the first three quarters of fiscal 2001. Internet sales have grown from an insignificant amount in fiscal 1996 to approximately $53.8 million in fiscal 2000 and from $38.1 million in the first three quarters of fiscal 2000 to $51.4 million in the first three quarters of fiscal 2001.

The Company's fiscal year consists of a 52/53 week period ending on the Saturday nearest to December 31.

The Company expenses all advertising costs when the advertising first takes place. As a result, quarter-to-quarter comparisons are impacted within and between quarters by the timing of television, radio and Internet advertisements and by the mailing of the Company's printed advertisements. The volume of mailings and other advertising may vary in different quarters and from year to year depending on the Company's assessment of prevailing market opportunities.

The sale and delivery of contact lenses are governed by both federal and state laws and regulations. The Company sells to customers in all 50 states, and each sale is likely to be subject to the laws of the state where the customer is located. In some states, the Company operates according to agreements it has entered into with local regulatory authorities or medical boards or agencies. The Company's general operating practice is to attempt to obtain a valid prescription from each of its customers or his/her eye care practitioner. If the customer does not have a copy of his/her prescription but does have the prescription information obtained directly from the customer's eye care practitioner, the Company attempts to contact the customer's eye care practitioner to obtain a copy of or verify the customer's prescription. If the Company is unable to obtain a copy of or verify the customer's prescription, it is the Company's general practice to complete the sale and ship the lenses to the customer based on the prescription information provided by the customer. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with the customer's prescriber.

On May 22, 2001, the Middle District Court in Jacksonville, Florida announced a preliminary settlement with Johnson & Johnson with respect to the multi-district litigation brought by the attorneys general of 32 states on behalf of a nationwide class of consumers. This suit alleged that consumers overpaid for contact lenses as a result of antitrust violations by Johnson &

Johnson, CIBA Vision, Bausch & Lomb, and the American Optometric Association ("AOA"). Specifically, the attorneys general alleged that the manufacturers and the AOA conspired to eliminate competition from alternative distribution channels, including mail order companies, and ensure that contact lenses would only be available from eye care professionals. The court finalized the settlement agreement on November 1, 2001. The agreement will be effective on December 1, 2001 provided there are no appeals to the settlement agreement. CIBA Vision settled this lawsuit four years ago and Bausch & Lomb settled early this year. The Company now purchases lenses directly from these two manufacturers.

Johnson & Johnson's press release announcing the settlement stated that it would begin selling to alternative channels of distribution. To date, Johnson & Johnson's eye care division, Vistakon, has refused to open an account with the Company. The Company is not aware of any mail order company that has begun purchasing directly from Vistakon. In October 2001, the Company was granted intervener status to this multi-district litigation by the court. This status allows the Company to become a party to the lawsuit for the limited purpose of enforcing the injunctive relief provisions of the settlement agreement, e.g. requiring Vistakon to sell its products directly to the Company.

Vistakon's current interpretation of the settlement agreement, and its subsequent actions, have made its products more difficult for the Company to obtain. This restricted supply and the resulting wholesale price increases have reduced the Company's expectations for its short-term net sales and gross profit.

The Company is also investing significant resources to ensure that the settlement agreement will allow mail order companies to purchase contact lenses directly from Vistakon. As a result, the Company expects to incur significant legal and related expenses for the remainder of fiscal 2001.

In response to Johnson & Johnson's efforts to make its products more difficult to obtain, the Company recently tested whether it could successfully transition its customers into new products by assisting them in getting fitted for a new brand of contact lenses. The Company believes that these tests indicate that its customers are receptive to an offer from the Company to try both a new product and a new eye care provider. The Company feels that a more active role in the product/provider decision may help it address the policies of manufacturers that refuse to sell their brands to the Company but seek to sell their brands exclusively to eye doctors.

On October 18, 2001, Vistakon filed an action against the Company concerning certain of its communications with customers informing them of the Company's belief that there are superior products available from other manufacturers with less restrictive distribution policies. See Note 6 to the Company's condensed consolidated financial statements.

Results of Operations

The following table presents the Company's results of operations expressed as a percentage of net sales for the periods indicated:

	Quarter Ended		Three Quarters En	
	September 30, 2000	September 29, 2001	September 30, 2000	Septemb 20

Net sales	100.0%	100.0%	100.0%	1
Cost of goods sold	59.8	60.5	59.5	
Gross profit	40.2	39.5	40.5	
Advertising expense	19.5	17.6	18.7	
Legal and professional fees	0.4	2.3	0.6	
Other selling, general and administrative expenses	9.9	11.9	10.2	
Total selling, general and administrative expenses	29.8	31.8	29.5	
Income from operations	10.4	7.7	11.0	
Other income (expense), net	0.0	(0.1)	0.2	
Income before provision for income taxes	10.4	7.6	11.2	
Provision for income taxes	(4.1)	(2.9)	(4.3)	
Net income	6.3%	4.7%	6.9%	

Net sales. Net sales for the quarter ended September 29, 2001 increased 9% to $44.4 million from $40.7 million for the quarter ended September 30, 2000. For the three quarters ended September 29, 2001, net sales increased 22% to $131.4 million from $107.9 million for the three quarters ended September 30, 2000. The Company added more than 450,000 new customers during the first three quarters of fiscal 2001. In addition, the Company continues to realize the benefits of repeat sales from a growing customer base. Repeat sales for the third quarter of fiscal 2001 increased 25% to $31.5 million, or 71% of net sales, from $25.3 million, or 62% of net sales, for the third quarter of fiscal 2000. Repeat sales for the first three quarters of fiscal 2001 increased 38% to $90.4 million, or 69% of net sales, from $65.6 million, or 61% of net sales, for the first three quarters of fiscal 2000. The Company also believes that the increase in net sales reflects some of the benefits of the nearly $100 million it has

invested in its national advertising campaign over the last several years and its commitment to customer service. In addition to refining its marketing efforts to its customer base, the Company has also enhanced its website and has increased the exposure of its website in its advertising. Internet sales for the third quarter of fiscal 2001 were $18.1 million, or 41% of net sales, as compared to $16.2 million, or 40% of net sales, for the third quarter of fiscal 2000. For the first three quarters of fiscal 2001, Internet sales were $51.4 million, or 39% of net sales, as compared to $38.1 million, or 35% of net sales, for same period in fiscal 2000. Due to the current environment (higher prices for and reduced supply of Vistakon products), the Company suspended its quantity discounts on all Vistakon contact lenses in June 2001. In September 2001, the Company implemented other programs to manage its level of Vistakon inventory, including reducing the standard quantity of Vistakon contact lenses offered to customers. These steps not only impacted net sales in the third quarter of fiscal 2001 but will also reduce expected revenues in the fourth quarter of fiscal 2001. The Company also estimates that third quarter 2001 net sales were reduced by more than $1.5 million by the events of September 11, 2001.

Gross profit. Gross profit as a percentage of net sales decreased to 39.5% for the quarter ended September 29, 2001 from 40.2% for the quarter ended September 30, 2000. For the three quarters ended September 29, 2001, gross profit as a percentage of net sales decreased to 40.1% from 40.5% for the three quarters ended September 30, 2000. Internet sales as a percentage of net sales impacts gross profit as a percentage of net sales since Internet orders generate lower gross profit due to free shipping on those orders. During the third quarter of fiscal 2001, gross profit was impacted by the increase in wholesale prices paid for Vistakon products. At the beginning of the third quarter of fiscal 2001, the Company had approximately a three to four month supply of Vistakon lenses; therefore, the impact of the increase in wholesale prices was less significant in the third quarter. Gross profit in the fourth quarter of fiscal 2001 will be more significantly impacted by this increase in wholesale prices. The Company's wholesale prices on Vistakon products have continued to increase substantially and Vistakon products account for more than 40% of the Company's net sales. If supply of Vistakon products remains limited and wholesale prices remain higher than expected, gross profit will continue to be impacted significantly in future quarters.

Advertising expense. Advertising expense for the quarter ended September 29, 2001 decreased approximately $161,000, or 2%, from the quarter ended September 30, 2000. As a percentage of net sales, advertising expense decreased to 17.6% for the third quarter of fiscal 2001 from 19.5% for the third quarter of fiscal 2000. For the three quarters ended September 29, 2001, advertising expense increased $3.1 million, or 15%, from the three quarters ended September 30, 2000. As a percentage of net sales, advertising expense decreased to 17.7% for the first three quarters of fiscal 2001 from 18.7% for the first three quarters of fiscal 2000. Due to the current environment (higher prices for and reduced supply of Vistakon products), the Company decreased advertising spending below originally planned levels for the third quarter of fiscal 2001 and expects to decrease advertising spending below originally planned levels for the remainder of fiscal 2001. Currently, the Company believes that advertising spending in fiscal 2001 will be approximately 6% higher than its fiscal 2000 spending. However, if opportunities present themselves, the Company may increase advertising spending above currently planned levels.

Legal and professional fees. Legal and professional fees for the quarter ended September 29, 2001 increased $0.9 million, or 580%, from the quarter ended September 30, 2000. For the three quarters ended September 29, 2001, legal and professional fees increased $1.4 million, or 234%, from the three quarters ended September 30, 2000. As a percentage of net sales, legal and professional fees increased to 2.3% for the third quarter of fiscal 2001 from 0.4% for the third quarter of fiscal 2000. For the three quarters ended September 29, 2001, legal and professional fees as a percentage of net sales increased to 1.5% from 0.6% for the first three quarters of fiscal 2000. During the first three quarters of fiscal 2001, the Company incurred significant legal and professional fees related to its legal matters and its increased efforts to proactively influence the industry on behalf of itself and consumers. The Company expects to continue to incur significant legal and professional fees at least through the remainder of fiscal 2001 as it continues this proactive approach, including investing resources to ensure that the multi-district litigation settlement agreement with Johnson & Johnson will allow mail order companies to purchase contact lenses directly from Vistakon.

Other selling, general and administrative expenses. Other selling, general and administrative expenses for the quarter ended September 29, 2001 increased $1.3 million, or 31%, from the quarter ended September 30, 2000.

For the three quarters ended September 29, 2001, other selling, general and administrative expenses increased $3.6 million, or 33%, from the three quarters ended September 30, 2000. As a percentage of net sales, other selling, general and administrative expenses increased to 11.9% for the third quarter of fiscal 2001 from 9.9% for the third quarter of fiscal 2000. For the three quarters ended September 29, 2001, other selling, general and administrative expenses as a percentage of net sales increased to 11.1% from 10.2% for the first three quarters of fiscal 2000. The fixed portion of operating and payroll costs increased as the Company continues to expand its operating infrastructure and enhance its management team to meet the demands of current and future growth.

Other income (expense), net. Other income (expense) decreased to approximately ($36,000) and ($208,000) for the quarter and three quarters ended September 29, 2001, respectively, from approximately $26,000 and $260,000 for the quarter and three quarters ended September 30, 2000, respectively. Interest income decreased due to lower cash balances and lower interest rates. Interest expense increased due to increased use of the revolving credit facility. In addition, during the first quarter of fiscal 2001, the Company recorded a $220,000 loss related to the impairment of non-marketable securities.

Income taxes. The Company's effective tax rate for the quarter and three quarters ended September 29, 2001 was 38.7% and 38.9%, respectively. For the quarter and three quarters ended September 30, 2000, the Company's effective tax rate was 39.1% and 38.5% respectively. As of September 29, 2001, the Company had not provided a valuation allowance on deferred tax assets. The Company's future effective tax rate will depend upon future taxable income. The Company anticipates that its fiscal 2001 effective income tax rate will be approximately 39%.

Liquidity and Capital Resources

For the three quarters ended September 29, 2001 and September 30, 2000, net cash provided by operating activities was approximately $6.9 million and $11.2 million, respectively. In the fiscal 2001 period, cash was provided primarily by net income and an increase in accounts payable partially offset by an increase in inventories. In the fiscal 2000 period, cash was provided primarily by net income and increases in accounts payable, accrued liabilities and income taxes payable partially offset by an increase in inventories. In order to help ensure sufficient supply of inventory, the Company generally carries a higher level of inventory than if it were able to purchase directly from all contact lens manufacturers.

The Company used approximately $2.0 million and $1.1 million for investing activities in the three quarters ended September 29, 2001 and September 30, 2000, respectively. The majority of these amounts relate to capital expenditures for infrastructure improvements. Capital expenditures for the fiscal 2001 period were approximately $1.3 million. A portion of these expenditures relates to the expansion of the Company's leased distribution center and leased space used for its management and call center operations. Capital expenditures for the fiscal 2000 period were approximately $0.9 million. In addition, the Company acquired intangible assets for approximately $0.7 million during the fiscal 2001 period. During March 2000, the Company made a $220,000 investment in the stock of an entity in which a member of the Company's Board of Directors holds a significant ownership interest and serves as an officer and director. The Company anticipates additional capital expenditures for infrastructure as it continues to expand and improve operating facilities, telecommunications systems and management information systems in order to handle current and future growth. The Company presently anticipates that capital expenditures in fiscal 2001 will be approximately $1.6 million.

As of September 29, 2001, the Company had certain noncancelable commitments to purchase approximately $1.3 million of broadcast advertising through December 2001. In addition, the Company has entered into certain noncancelable commitments with various advertising companies that will require the Company to pay approximately $5.8 million from January 1, 2001 through December 31, 2001.

During the three quarters ended September 29, 2001 and September 30, 2000, the Company used approximately $3.6 million and $14.3 million for financing activities, respectively. During the fiscal 2001 period, the Company had net repayments on its credit facility of approximately $3.3 million and repurchased 22,500 shares

of its common stock for a total cost of approximately $438,000. During the fiscal 2000 period, the Company had net borrowings on its credit facility of approximately $2.5 million and repurchased a total of 1,084,000 shares of its common stock for a total cost of approximately $16.8 million. In both the fiscal 2001 and 2000 periods, these amounts were offset slightly by proceeds from the exercise of common stock options. In the fiscal 2000 period, the Company also made its final payment of $300,000 relating to the 1999 purchase of the assets of Contact Lenses Online, Inc.

On April 20, 2001, the Company's Board of Directors authorized an additional repurchase of up to 1,000,000 shares of its common stock, bringing the total authorization to 3,000,000 shares. A purchase of the full 3,000,000 shares would equal approximately 23.3 percent of the total shares issued. The repurchase of common stock is subject to market conditions and is accomplished through periodic purchases at prevailing prices on the open market, by block purchases or in privately negotiated transactions. The repurchased shares will be retained as treasury stock to be used for corporate purposes. Through September 29, 2001, the Company had repurchased 1,506,500 shares for a total cost of approximately $19.9 million.

The Company has a revolving credit facility to provide for working capital requirements and other corporate purposes. The credit facility provides for borrowings equal to the lesser of $20.0 million or 50 percent of eligible inventory and bears interest at a floating rate equal to the lender's prime interest rate minus 0.25 percent (5.75 percent as of September 29, 2001). As of September 29, 2001, the Company had no outstanding borrowings on the credit facility. The credit facility is secured by substantially all of the Company's assets and contains financial covenants customary for this type of financing. The credit facility expires April 30, 2003.

The Company believes that its cash on hand, together with cash generated from operations and the cash available through the credit facility, will be sufficient to support current operations and future growth through the next year. The Company may be required to seek additional sources of funds for accelerated growth or continued growth after that point, and there can be no assurance that such funds will be available on satisfactory terms. Failure to obtain such financing could delay or prevent the Company's planned growth, which could adversely affect the Company's business, financial condition and results of operations.

See "Overview" for a discussion regarding the multi-district litigation's potential impact on the Company's results of operations.

As a result of state regulatory requirements, the Company's liquidity, capital resources and results of operations may be negatively impacted in the future if the Company incurs increased costs or fines, is prohibited from selling its products in a particular state(s) or experiences losses of a portion of the Company's customers for whom the Company is unable to obtain or verify a prescription due to the enforcement of requirements by state regulatory agencies.

Recently Issued Accounting Standards

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, "Business Combinations," and No. 142, "Goodwill and Other Intangible Assets," effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of fiscal 2002. Also during fiscal 2002, the Company will perform the first of the required impairment tests of goodwill and indefinite lived intangible assets, to the extent applicable. The Company has not yet determined what the effect of these Statements will be on the Company's results of operations and financial position.

Forward-Looking Statements

Except for the historical information contained herein, the matters discussed in this Form 10-Q are forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and Section 27A of the Securities Act of 1933, as amended. These forward-looking statements involve risks and uncertainties and often depend on assumptions, data or methods that may be incorrect or imprecise. The Company's future operating results may differ materially from the results discussed in, or implied by, forward-looking statements made by the Company. Factors that may cause such differences include, but are not limited to, those discussed below and the other risks detailed in the Company's other reports filed with the Securities and Exchange Commission. The words such as "believes," "anticipates," "expects," "future," "intends," "would," "may" and similar expressions are intended to identify forward-looking statements. The Company undertakes no obligation to revise any of these forward-looking statements to reflect events or circumstances after the date hereof.

Factors That May Affect Future Results

- The Company's sales growth will not continue at historical rates and it may encounter unforeseen difficulties in managing its future growth;

- A significant portion of the Company's sales may not comply with applicable state laws and regulations governing the delivery and sale of contact lenses;

- Because the Company doesn't manufacture contact lenses, it cannot ensure that the contact lenses it sells meet all federal regulatory requirements;

- It is possible that the FDA will consider certain of the contact lenses the Company sells to be misbranded;

- The Company currently purchases a substantial portion of its products from unauthorized distributors and is not an authorized distributor for some of the products that it sells;

- The Company obtains a large percentage of its inventory from a limited number of suppliers, with a single distributor accounting for 47%, 38% and 35% of the Company's inventory purchases in fiscal 1998, 1999 and 2000, respectively;

- The Company's quarterly results are likely to vary based upon the level of sales and marketing activity in any particular quarter;

- The Company is dependent on its telephone, Internet and management information systems for the sale and distribution of contact lenses;

- The Company has limited operating history and, as a result, there is only limited financial information and operating information available for a potential investor to evaluate the Company;

- The retail sale of contact lenses is highly competitive; certain of the Company's competitors are large, national optical chains that have greater resources than the Company has;

- The demand for contact lenses could be substantially reduced if alternative technologies to permanently correct vision gain in popularity;

- The Company does not have any property rights in the 1-800 CONTACTS telephone number or the Internet addresses that it uses;

- Increases in the cost of shipping, postage or credit card processing could harm the Company's business;

- The Company's business could be harmed if it is required to collect state sales tax on the sale of products;

- The Company faces an inherent risk of exposure to product liability claims in the event that the use of the products it sells results in personal injury;

- The Company conducts its operations through a single distribution facility;

- The Company's success is dependent, in part, on continued growth in use of the Internet;

- Government regulation and legal uncertainties relating to the Internet and online commerce could negatively impact the Company's business operations; and

- Changing technology could adversely affect the operation of the Company's website.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company is exposed to changes in interest rates primarily related to its revolving credit facility. As of September 29, 2001, the Company had no outstanding borrowings on the credit facility. The credit facility bears interest at a variable rate. The Company is exposed to foreign currency risk due to cash held by its foreign subsidiary. As of September 29, 2001, the Company's total cash in foreign currencies was approximately $12,000. In addition, all of the Company's revenue transactions are in U.S. dollars.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

See notes to condensed consolidated financial statements.

Item 2. Changes in Securities and Use of Proceeds

None.

Item 3. Defaults upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

From time to time the Company receives notices, inquiries or other correspondence from states or its regulatory bodies charged with overseeing the sale of contact lenses. The Company's practice is to review such notices with legal counsel to determine the appropriate response on a case-by-case basis. It is the opinion of management, after discussion with legal counsel, that the Company is taking the appropriate steps to address the various notices received.

Item 6. Exhibits and Reports on Form 8-K

(A) Exhibits

None.

(B) Reports on Form 8-K

No reports on Form 8-K were filed by the Registrant during the quarter ended September 29, 2001.

SIGNATURES

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

1-800 CONTACTS, INC.

Dated: November 13, 2001 By: /s/ Jonathan C. Coon

Name: Jonathan C. Coon

Title: President and Chief Executive Officer

By: /s/ Scott S. Tanner

Name: Scott S. Tanner
Title: Chief Operating Officer and Chief Financial Officer