RED ROBIN GOURMET BURGERS INC
Form 10-Q
November 06, 2009
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 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 October 4, 2009

or

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

For the transition period from to

Commission File Number: 0-49916

RED ROBIN GOURMET BURGERS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**84-1573084**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6312 S. Fiddler s Green Circle, Suite 200N	
Greenwood Village, CO	**80111**
(Address of principal executive offices)	(Zip Code)

(303) 846-6000

(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

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

Class	**Outstanding at November 3, 2009**
Common Stock, $0.001 par value per share	15,580,644 shares

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

RED ROBIN GOURMET BURGERS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)
(Unaudited)

		October 4, 2009		December 28, 2008
Assets:				
Current Assets:				
Cash and cash equivalents	$	8,860	$	11,158
Accounts receivable, net		7,944		5,611
Inventories		13,739		13,123
Prepaid expenses and other current assets		7,714		9,032
Income tax receivable		1,120		6,208
Deferred tax asset		6,502		3,366
Restricted current assets marketing funds		1,132		1,590
Total current assets	$	47,011	$	50,088
Property and equipment, net		434,965		442,012
Goodwill		61,769		60,982
Intangible assets, net		49,478		51,990
Other assets, net		3,728		4,665
Total assets	$	596,951	$	609,737
Liabilities and Stockholders Equity:				
Current Liabilities:				
Trade accounts payable	$	9,742	$	11,966
Construction related payables		2,485		9,747
Accrued payroll and payroll related liabilities		26,082		25,489
Unearned revenue		8,649		11,997
Accrued liabilities		22,476		20,385
Accrued liabilities marketing funds		1,132		1,590
Current portion of term loan notes payable		18,739		10,313
Current portion of long-term debt and capital lease obligations		654		696
Total current liabilities	$	89,959	$	92,183
Deferred rent		30,017		26,790
Long-term portion of term loan notes payable		103,954		122,687
Other long-term debt and capital lease obligations		74,239		88,876
Other non-current liabilities		10,167		10,293
Total liabilities	$	308,336	$	340,829
Stockholders Equity:				
Common stock; $0.001 par value: 30,000,000 shares authorized; 17,072,249 and 16,954,205 shares issued; 15,579,969 and 15,461,925 shares outstanding		17		17
Preferred stock, $0.001 par value: 3,000,000 shares authorized; no shares issued and outstanding				
Treasury stock, 1,492,280 shares, at cost		(50,125)		(50,125)
Paid-in capital		169,612		165,932
Accumulated other comprehensive loss, net of tax		(1,563)		(1,622)
Retained earnings		170,674		154,706
Total stockholders equity		288,615		268,908
Total liabilities and stockholders equity	$	596,951	$	609,737

See notes to condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)
(Unaudited)

	Twelve Weeks Ended		Forty Weeks Ended	
	October 4, 2009	October 5, 2008	October 4, 2009	October 5, 2008
Revenues:				
Restaurant revenue	$ 183,878	$ 205,286	$ 648,436	$ 659,086
Franchise royalties and fees	3,035	3,299	10,265	11,367
Rent revenue	34	53	147	166
Total revenues	186,947	208,638	658,848	670,619
Costs and expenses:				
Restaurant operating costs:				
Cost of sales	42,961	48,705	156,472	156,558
Labor (includes $126, $298, $1,249 and $961 of stock-based compensation, respectively)	64,113	68,300	224,063	222,395
Operating	31,950	36,236	106,976	113,139
Occupancy	14,434	13,977	47,836	43,195
Depreciation and amortization	13,112	12,248	43,815	38,777
General and administrative (includes $600, $1,886, $4,942, and $4,400 of stock-based compensation, respectively)	12,109	15,659	51,080	52,588
Pre-opening costs	125	2,661	3,263	7,265
Asset impairment charge		928		928
Reacquired franchise and other acquisition costs				451
Total costs and expenses	178,804	198,714	633,505	635,296
Income from operations	8,143	9,924	25,343	35,323
Other expense (income):				
Interest expense, net	1,321	2,045	4,994	6,104
Other	10	7	29	(18)
Total other expenses	1,331	2,052	5,023	6,086
Income before income taxes	6,812	7,872	20,320	29,237
Provision for income taxes	1,110	1,698	4,352	7,894
Net income	$ 5,702	$ 6,174	$ 15,968	$ 21,343
Earnings per share:				
Basic	$ 0.37	$ 0.40	$ 1.04	$ 1.32
Diluted	$ 0.37	$ 0.40	$ 1.03	$ 1.31
Weighted average shares outstanding:				
Basic	15,408	15,303	15,379	16,113
Diluted	15,535	15,415	15,488	16,251

See notes to condensed consolidated financial statements.

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RED ROBIN GOURMET BURGERS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)
(Unaudited)

	Forty Weeks Ended October 4, 2009	Forty Weeks Ended October 5, 2008
Cash Flows From Operating Activities:		
Net income	$ 15,968	$ 21,343
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	43,815	38,777
Stock-based compensation expense	6,191	5,361
Asset impairment charge		928
Restaurant closure costs	598	
Other, net	(3,557)	231
Changes in operating assets and liabilities	3,495	219
Cash provided by operating activities	66,510	66,859
Cash Flows From Investing Activities:		
Changes in marketing fund restricted cash		81
Acquisition of franchise restaurants, net of cash acquired of $0 and $55, respectively	(1,248)	(30,389)
Purchases of property and equipment	(40,776)	(65,223)
Cash used in investing activities	(42,024)	(95,531)
Cash Flows From Financing Activities:		
Borrowings of long-term debt	147,900	155,900
Payments of long-term debt	(171,815)	(85,387)
Purchase of treasury stock		(50,042)
Payment for tender offer for stock options	(3,498)	
Proceeds from exercise of stock options and employee stock purchase plan	937	1,456
Excess tax benefit related to exercise of stock options	155	278
Payments of other debt and capital lease obligations	(463)	(414)
Cash provided (used) by financing activities	(26,784)	21,791
Net change in cash and cash equivalents	(2,298)	(6,881)
Cash and cash equivalents, beginning of period	11,158	12,914
Cash and cash equivalents, end of period	$ 8,860	$ 6,033
Supplemental Disclosure of Cash Flow Information:		
Income taxes paid	$ 2,103	$ 4,216
Interest paid, net of amounts capitalized	5,089	5,959
Supplemental Disclosure of Non-Cash Items:		
Capital lease obligations incurred for equipment purchases		156
Unrealized gain (loss) on swap, net of tax	53	356

See notes to condensed consolidated financial statements.

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RED ROBIN GOURMET BURGERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation and Recent Accounting Pronouncements

Red Robin Gourmet Burgers, Inc. (Red Robin or the Company), a Delaware corporation, develops and operates casual-dining restaurants. At October 4, 2009, the Company operated 304 company-owned restaurants located in 31 states. The Company also franchises the Red Robin® restaurant concept. As of October 4, 2009, 21 franchisees operated 132 franchised restaurants in 21 states and two Canadian provinces. The Company currently does not sell new franchises, but does grant current franchisees the right to develop additional franchised restaurants from time to time. The Company operates its business as one operating segment and one reporting unit.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of Red Robin and its majority owned and controlled subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. The Company s financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates included in the preparation of these financial statements pertain to recoverability of long-lived assets, fixed asset lives, recoverability of goodwill, estimated useful lives of other intangible assets, bonus accruals, self-insurance liabilities, stock-based compensation expense, legal contingencies, fair value of assets acquired in a business combination and income taxes. Actual results could differ from those estimates. The results of operations for any interim period are not necessarily indicative of results for the full year.

The accompanying condensed consolidated financial statements of Red Robin have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in the Company s annual consolidated financial statements on Form 10-K have been condensed or omitted. The condensed consolidated balance sheet as of December 28, 2008 has been derived from the audited consolidated financial statements as of that date, but does not include all disclosures required by generally accepted accounting principles. For further information, please refer to and read these interim condensed consolidated financial statements in conjunction with the Company s audited consolidated financial statements included in the Company s annual report on Form 10-K for the year ended December 28, 2008.

The Company s quarter which ended October 4, 2009, is referred to as third quarter 2009, or the twelve weeks ended October 4, 2009; the second quarter ended July 12, 2009, is referred to as second quarter 2009 or the twelve weeks ended July 12, 2009; and the first quarter ended April 19, 2009, is referred to as first quarter 2009, or the sixteen weeks ended April 19, 2009; and, together the first, second, and third quarters of 2009 are referred to as the forty weeks ended October 4, 2009. The Company s quarter which ended October 5, 2008, is referred to as third quarter 2008, or the twelve weeks ended October 5, 2008; the second quarter ended July 13, 2008, is referred to as second quarter 2008 or twelve weeks ended July 13, 2008; and the first quarter ended April 20, 2008, is referred to as first quarter 2008, or the sixteen weeks ended April 20, 2008; and, together the first, second, and third quarters of 2008 are referred to as the forty weeks ended October 5, 2008.

Reclassifications

Certain reclassifications have been made to prior year amounts in the condensed consolidated statements of cash flows to conform to the current year presentation to reflect the gross borrowings and repayments of long-term debt.

Recent Accounting Pronouncements

In June 2009, Financial Accounting Standards Board (FASB) issued Statement of Accounting Standards (SFAS) No. 168, *The FASB Accounting Standards CodificationTM and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No. 162*, (SFAS 168). SFAS 168 provides for the FASB Accounting Standards CodificationTM (the ASC) to become the single official source of authoritative, nongovernmental U.S. generally accepted accounting principles (GAAP). The ASC did not change GAAP but reorganizes the literature. SFAS 168 is incorporated into section 105 of the ASC and is effective for interim and annual periods ending after September 15, 2009. Beginning in the third quarter of fiscal 2009, all references to authoritative accounting literature in the Company s financial statements are referenced in accordance with the ASC. There are no changes to the content of the Company s financial statements or disclosures as a result of implementing the ASC.

In August 2009, the FASB issued the Accounting Standards Update (Update) No. 2009-05, *Measuring Liabilities at Fair Value,* (Update 2009-05). This update amends ASC 820, *Fair Value Measurements and Disclosures*. Update 2009-5 provides additional clarification for the fair value measurement of liabilities, specifically in circumstances in which a quoted price in an active market is not available or when the liability contains transfer restrictions. Update 2009-5 is effective for financial reporting periods beginning the period after issuance of the update. The Company will adopt this update in the fourth quarter of 2009 and does not expect the adoption of Update 2009-5 to have a material impact on its consolidated financial statements.

In May 2009, the FASB issued SFAS No. 165, *Subsequent Events,* (which is now found under ASC 855, *Subsequent Events*), which was effective for financial periods ending after June 15, 2009. The guidance establishes general standards of accounting for and disclosure of subsequent events that occur after the balance sheet date. The Company adopted SFAS 165 during the second quarter 2009. Refer to Note 11 *Subsequent Events* for disclosure.

In April 2009, the FASB issued FASB Staff Position (FSP) Nos. 107-1 and Accounting Principles Board (APB) 28-1, *Interim Disclosures about Fair Value of Financial Instruments,* (FSP FAS 107-1). This guidance is now found under ASC 825, *Financial Instruments*. FSP FAS 107-1 amends SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, and APB No. 28, *Interim Financial Reporting* (also found under the topic ASC 825, *Financial Instruments*). The guidance requires fair value disclosures on an interim basis for financial instruments that are not reflected in the condensed consolidated balance sheets at fair value. Prior to the issuance of FSP FAS 107-1, the fair values of those financial instruments were only disclosed on an annual basis. FSP FAS 107-1 is effective for interim reporting periods that end after the Company s second quarter. The adoption of FSP FAS 107-1 did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In April 2008, the FASB issued FSP No. FAS 142-3, *Determination of the Useful Life of Intangible Assets*, (FSP 142-3). This guidance is now found under ASC 350, *Intangibles Goodwill and Other*. FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), which is also found under ASC 350. The requirement for determining useful lives must be applied prospectively to intangible assets acquired after the effective date and the disclosure requirements must be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. This guidance is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of this guidance at the beginning of fiscal 2009 did not have a material impact on the Company s consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, (SFAS 161). This guidance is now found under ASC 815 *Derivatives and Hedging*. This guidance provides companies with requirements for enhanced disclosures about derivative instruments and hedging activities to enable investors to better understand their effects on a company s financial position, financial performance and cash flows. These requirements include the disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. The Company adopted the guidance at the beginning of fiscal 2009.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations,* (SFAS 141R). This guidance is now found under ASC 805, *Business Combinations*. This guidance provides companies with principles and requirements on how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree as well as the recognition and measurement of goodwill acquired in a business combination. The guidance also requires certain disclosures to enable users of the financial statements to evaluate the nature and financial effects of the business combination. Acquisition costs associated with the business combination will generally be expensed as incurred. This guidance is effective for business combinations occurring in fiscal years beginning after December 15, 2008. Accordingly, beginning in fiscal 2009, the Company will record and disclose material business combinations under the revised standard.

In December 2007, the FASB issued SFAS No. 160*, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*, (SFAS 160). This guidance is now found under ASC 810, *Consolidation*. This guidance changes the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity. The Company adopted the guidance at the beginning of fiscal 2009. The adoption of this guidance did not impact the Company s consolidated financial statements.

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2. Restaurant Closures

The Company closed four company-owned restaurants during the first quarter of 2009. This decision resulted from an initiative to identify those restaurants that were located in declining trade areas, performed below acceptable profitability levels and/or required significant capital expenditures. The locations selected for closure represented older restaurants whose leases were not extended, or were in need of significant capital improvement that were not projected to provide acceptable returns in the foreseeable future. The Company recognized a charge of approximately $598,000 related to lease termination costs based on estimated remaining lease obligations, net of estimated sublease income, and other closing related costs. This charge was recorded in the Company s condensed consolidated statements of income as general and administrative expense for the forty weeks ended October 4, 2009.

3. Cash Tender Offer

On February 11, 2009, the Company completed a cash tender offer for out-of-the-money stock options held by 514 then current employees and officers. The stock options eligible for tender were granted prior to December 31, 2008 with an exercise price at or above $32.00 per share. Pursuant to the terms of the tender offer, eligible employees and officers who elected to participate were required to tender all of their eligible options. As a result of the tender offer, the Company incurred a one-time charge of approximately $4.0 million for all unvested eligible options that were tendered. This first quarter 2009 charge is reflected in the financial results for the forty weeks ended October 4, 2009 and represents the compensation expense related to the acceleration of vesting on the unvested options tendered in the offer, which would otherwise have been expensed over their vesting period in the future if they had not been tendered. The Company paid $3.5 million for the approximate 1.6 million options tendered in the offer.

4. Stock-Based Compensation

During the twelve weeks ended October 4, 2009, the Company issued approximately 36,000 options with a weighted average grant date fair value of $8.58 per share and a weighted average exercise price of $19.97 per share. For the forty weeks ended October 4, 2009, the Company issued approximately 402,000 options with a weighted average grant date fair value of $6.22 per share and a weighted average exercise price of $15.69 per share. Compensation expense for these options is recognized over the remaining weighted average vesting period which is approximately 1.5 years.

The fair value of options at the grant date was estimated utilizing the Black-Scholes multiple option-pricing model with the following weighted average assumptions for the periods presented:

	Twelve Weeks Ended		Forty Weeks Ended	
	October 4, 2009	October 5, 2008	October 4, 2009	October 5, 2008
Risk-free interest rate	1.7%	2.3%	1.5%	1.9%
Expected years until exercise	3.6	2.7	3.6	2.7
Expected stock volatility	58.2%	42.7%	52.9%	40.5%
Dividend yield	0.0%	0.0%	0.0%	0.0%

Weighted-average Black-Scholes fair value per share at date of grant	$ 8.58	$ 7.52	$ 6.22	$ 9.71

During the twelve weeks ended October 4, 2009, the Company did not issue any shares of non-vested common stock under its Amended and Restated 2007 Performance Incentive Plan (the 2007 Stock Plan). The Company has issued approximately 34,500 shares of non-vested common stock under the 2007 Stock Plan with a weighted average grant date fair value of $15.28 for the forty weeks ended, October 4, 2009. Compensation expense for the aggregate 151,000 shares of non-vested common stock outstanding at October 4, 2009, is recognized over the remaining weighted average vesting period which is approximately 1.7 years. The outstanding non-vested shares of common stock granted to directors are generally subject to a one year vesting requirement, while outstanding non-vested shares of common stock granted to executive officers and other key employees are generally subject to a four year graded vesting requirement.

During the twelve weeks ended October 4, 2009, the Company issued approximately 600 restricted stock units (RSUs) to certain employees under its 2007 Stock Plan with a weighted average grant date fair value of $18.99. For the forty weeks ended October 4, 2009, the Company issued approximately 38,000 RSUs to certain employees under its 2007 Stock Plan with a weighted average grant date fair value of $15.18. The RSUs vest in equal installments over four years on the anniversary date and upon vesting, one share of the Company s common stock is issued for each RSU. The fair value of each RSU granted is equal to the market price of the Company s stock at the date of grant. Compensation expense for the RSUs is recognized over the remaining weighted average vesting period which is approximately 1.9 years.

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Included in restaurant labor and general and administrative expenses in the condensed consolidated statements of income for the forty weeks ended October 4, 2009, is approximately $886,000 and $3.1 million respectively, of stock-based compensation expense related to the cash tender offer discussed in Note 3 *Cash Tender Offer*. This one-time charge incurred in the first quarter 2009, represents the compensation expense related to the acceleration of vesting on the unvested options tendered in the offer, which would otherwise have been expensed over their vesting period in the future if they had not been tendered.

For the twelve and forty weeks ended October 4, 2009, $24,000 and $72,000 of stock-based compensation was recognized as capitalized development and is included in property and equipment in the condensed consolidated balance sheet, respectively. During the twelve weeks ended October 4, 2009, approximately 28,000 options to purchase common shares were exercised and approximately 55,000 options were forfeited. During the forty weeks ended October 4, 2009, approximately 52,000 options to purchase common shares were exercised and approximately 1.7 million options were cancelled due primarily to the cash tender offer discussed in Note 3 *Cash Tender Offer.*

5. Earnings Per Share

Basic earnings per share amounts are calculated by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per share amounts are calculated by dividing net income by the weighted-average number of common and potentially dilutive common shares outstanding during the period. Potentially dilutive shares are excluded from the computation in periods in which they have an anti-dilutive effect.

Diluted earnings per share reflect the potential dilution that could occur if holders of options exercised their options into common stock. During the twelve and forty weeks ended October 4, 2009, approximately 363,000 and 864,000, respectively, weighted stock options outstanding were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented. During the twelve and forty weeks ended October 5, 2008, approximately 1.9 million and 1.7 million stock options outstanding, respectively, were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented. The Company uses the treasury stock method to calculate the impact of outstanding stock options. The computations for basic and diluted earnings per share are as follows (in thousands, except per share data):

	Twelve Weeks Ended		Forty Weeks Ended	
	October 4, 2009	**October 5, 2008**	**October 4, 2009**	**October 5, 2008**
Net income	$ 5,702	$ 6,174	$ 15,968	$ 21,343
Basic weighted-average shares outstanding	15,408	15,303	15,379	16,113
Dilutive effect of stock options and awards	127	112	109	138
Diluted weighted-average shares outstanding	15,535	15,415	15,488	16,251
Earnings per share:				
Basic	$ 0.37	$ 0.40	$ 1.04	$ 1.32
Diluted	$ 0.37	$ 0.40	$ 1.03	$ 1.31

6. Advertising Costs

Costs incurred in connection with the advertising and promotion of the Company are included in operating expenses and expensed as incurred. Such costs amounted to $3.9 million and $11.8 million for the twelve and forty weeks ended October 4, 2009, respectively and $5.7 million and $18.2 million for the twelve and forty weeks ended October 5, 2008, respectively.

Under the Company s franchise agreements, both the Company and the franchisees must contribute a minimum percentage of revenues to two marketing and national media advertising funds (the Marketing Funds). These Marketing Funds are used to develop and distribute Red Robin® branded marketing materials, for media purchases and for administrative costs. The Company s portion of costs incurred by the Marketing Funds is recorded as operating and general and administrative expenses in the Company s financial statements. Restricted assets represent contributed funds held for future use.

7. Derivative and Hedging Activities

The Company enters into derivative instruments for risk management purposes only, including derivatives designated as hedging instruments under ASC 815, *Derivatives and Hedging*. The Company uses interest rate-related derivative instruments to manage its exposure to fluctuations of interest rates. By using these instruments, the Company exposes itself, from time to time, to credit risk and market risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When

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the fair value of a derivative contract is positive, the counterparty owes the Company, which creates credit risk for the Company. The Company minimizes the credit risk by entering into transactions with high-quality counterparties whose credit rating is evaluated on a quarterly basis. The Company s counterparty in the interest rate swap is SunTrust Bank, National Association (SunTrust). Market risk, as it relates to the Company s interest-rate derivative, is the adverse effect on the value of a financial instrument that results from a change in interest rates, commodity prices, or the market price of the Company s common stock. The Company minimizes market risk by establishing and monitoring parameters that limit the types and degree of market risk that may be taken.

In March 2008, the Company entered into a variable-to-fixed interest rate swap agreement with SunTrust to hedge the Company s floating interest rate on an aggregate of up to $120 million of debt that is currently outstanding under the Company s amended and restated credit facility. The interest rate swap has an effective date of March 19, 2008 and a termination date of March 19, 2010 for $50 million of the initial $120 million and March 19, 2011 for the remaining $70 million. The agreement was designated as a cash flow hedge under which the Company is required to make payments based on a fixed interest rate of 2.7925% calculated on an initial notional amount of $120 million. In exchange the Company will receive interest on a $120 million of notional amount at a variable rate that is based on the 3-month LIBOR rate.

The Company entered into the above interest rate swap with the objective of offsetting the variability of its interest expense that arises because of changes in the variable interest rate for the designated interest payments. Changes in the fair value of the interest rate swap are reported as a component of accumulated other comprehensive income (AOCI). The Company reclassifies gain or loss from accumulated other comprehensive income, net of tax, on the Company s consolidated balance sheet to interest expense on the Company s consolidated statement of income as the interest expense is recognized on the related debt.

The following table summarizes the fair value and presentation in the condensed consolidated balance sheets of the interest rate swap designated as hedging instruments under ASC 815 as of October 4, 2009 (in thousands):

Balance Sheet Location	**Derivative Assets**	**Derivative Liabilities**
Accrued liabilities	$	$ 2,111
Other non-current liabilities		453
Total derivatives	$	$ 2,564

The following table summarizes the effect of the interest rate swap on the condensed consolidated statements of income for the twelve and forty weeks ended October 4, 2009 (in thousands):

	Twelve Weeks Ended October 4, 2009	**Forty Weeks Ended October 4, 2009**
Unrealized loss on swap in AOCI (pretax)	$ (353)	$ (1,496)
Realized loss (pretax effective portion) recognized in interest expense	$ (626)	$ (1,582)