

GART SPORTS CO
Form 10-Q
November 27, 2002

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934

For the Quarterly Period Ended: November 2, 2002

Commission File Number: 000-23515

GART SPORTS COMPANY

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation or organization)

84-1242802
(I.R.S. Employer
Identification No.)

1050 West Hampden Avenue, Englewood, Colorado 80110

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (303) 200-5050

Indicate by check mark whether the registrant 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 shorter period that the registrant was required to file such reports). Yes No

Indicate by check mark whether the registrant has been subject to such filing requirements for the past 90 days. Yes No

As of November 19, 2002, there were outstanding 11,862,419 shares of the registrant's common stock, \$.01 par value, and the aggregate market value of the shares (based upon the closing price on that date of the shares on the NASDAQ National Market) held by non-affiliates was approximately \$181,809,000.

GART SPORTS COMPANY
QUARTERLY PERIOD ENDED NOVEMBER 2, 2002
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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

**GART SPORTS COMPANY
AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS**

(Dollars in Thousands, Except Share and Per Share Amounts)

| | November 2, 2002 | February 2, 2002 |
|--|---------------------|---------------------|
| | (Unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 10,531 | \$ 11,536 |
| Accounts receivable, net of allowance for doubtful accounts of \$814 and \$1,116 | 14,369 | 11,831 |
| Inventories | 416,677 | 326,543 |
| Prepaid expenses and other assets | 11,204 | 9,796 |
| Deferred income taxes | 15,014 | 12,471 |

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| | November 2, 2002 | February 2, 2002 |
|---|---------------------|---------------------|
| Total current assets | 467,795 | 372,177 |
| Property and equipment, net | 86,691 | 87,615 |
| Favorable leases, net of accumulated amortization of \$2,574 and \$1,196 | 11,506 | 12,884 |
| Deferred income taxes | 10,669 | 13,788 |
| Goodwill, net of accumulated amortization of \$734 | 44,576 | 41,301 |
| Other assets, net of accumulated amortization of \$7,726 and \$5,227 | 7,748 | 8,417 |
| Total assets | \$ 628,985 | \$ 536,182 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 212,713 | \$ 171,888 |
| Current portion of capital lease obligations | 685 | 634 |
| Accrued expenses and other current liabilities | 50,447 | 57,161 |
| Total current liabilities | 263,845 | 229,683 |
| Long-term debt | 164,658 | 158,474 |
| Capital lease obligations, less current portion | 1,284 | 1,821 |
| Deferred rent and other long-term liabilities | 13,533 | 10,695 |
| Total liabilities | 443,320 | 400,673 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, \$.01 par value. 3,000,000 shares authorized; none issued | | |
| Common stock, \$.01 par value. 22,000,000 shares authorized; 13,435,173 and 11,340,341 shares issued and 11,862,419 and 10,728,986 shares outstanding | 134 | 113 |
| Additional paid-in capital | 156,889 | 99,355 |
| Unamortized restricted stock compensation | (2,152) | (2,743) |
| Accumulated other comprehensive loss | (806) | (448) |
| Retained earnings | 55,076 | 44,755 |
| Treasury stock, 1,572,754 and 611,355 common shares, at cost | (23,476) | (5,523) |
| Total stockholders' equity | 185,665 | 135,509 |
| Total liabilities and stockholders' equity | \$ 628,985 | \$ 536,182 |

See accompanying notes to consolidated financial statements.

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(Unaudited, Dollars in Thousands, Except Share and Per Share Amounts)

| | Thirteen weeks ended | | Thirty-nine weeks ended | |
|--|----------------------|---------------------|-------------------------|---------------------|
| | November 2, 2002 | November 3, 2001 | November 2, 2002 | November 3, 2001 |
| Net sales | \$ 227,762 | \$ 219,142 | \$ 734,443 | \$ 619,722 |
| Cost of goods sold, buying, distribution and occupancy | 170,795 | 164,704 | 547,963 | 466,636 |
| Gross profit | 56,967 | 54,438 | 186,480 | 153,086 |
| Operating expenses | 53,307 | 52,316 | 163,584 | 139,192 |
| Merger integration costs | | 3,603 | | 7,080 |
| Operating income (loss) | 3,660 | (1,481) | 22,896 | 6,814 |
| Non operating income (expense): | | | | |
| Interest expense, net | (1,542) | (2,590) | (6,658) | (7,313) |
| Other income | 191 | 962 | 630 | 1,488 |
| Income (loss) before income taxes | 2,309 | (3,109) | 16,868 | 989 |
| Income tax (expense) benefit | (912) | 1,213 | (6,547) | (385) |
| Net income (loss) | \$ 1,397 | \$ (1,896) | \$ 10,321 | \$ 604 |
| Earnings (loss) per share: | | | | |
| Basic | \$ 0.12 | \$ (0.18) | \$ 0.88 | \$ 0.07 |
| Diluted | \$ 0.11 | \$ (0.18) | \$ 0.82 | \$ 0.06 |
| Weighted average shares of common stock outstanding: | | | | |
| Basic | 12,076,645 | 10,803,273 | 11,734,135 | 9,232,749 |
| Diluted | 12,755,349 | 10,803,273 | 12,563,849 | 9,913,102 |

See accompanying notes to consolidated financial statements.

GART SPORTS COMPANY
AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(Unaudited, Dollars in Thousands)

| | Common stock | Additional paid-in capital | Unamortized restricted stock compensation | Accumulated other comprehensive loss | Retained earnings | Comprehensive income | Treasury stock | Total Stockholders' equity |
|---------------------------------|-----------------|----------------------------------|--|---|----------------------|-------------------------|-------------------|----------------------------------|
| BALANCES AT FEBRUARY 2, 2002 | \$ 113 | \$ 99,355 | \$ (2,743) | \$ (448) | \$ 44,755 | \$ (5,523) | \$ | \$ 135,509 |

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| | Common stock | Additional paid-in capital | Unamortized restricted stock compensation | Accumulated other comprehensive loss | Retained earnings | Comprehensive income | Treasury stock | Total Stockholders' equity |
|---|-----------------|----------------------------------|--|---|----------------------|-------------------------|--------------------|----------------------------------|
| Net income | | | | | 10,321 | \$ 10,321 | | 10,321 |
| Unrealized loss on equity securities, net of tax | | | | (136) | | (136) | | (136) |
| Unrealized loss on interest rate swap, net of tax | | | | (222) | | (222) | | (222) |
| Comprehensive income | | | | | | \$ 9,963 | | |
| Issuance of common stock | | 25 | | | | | | 25 |
| Exercise of stock options | 3 | 5,412 | | | | | | 5,415 |
| Issuance of restricted stock | | 153 | (153) | | | | | |
| Repurchase and retirement of restricted stock | | (37) | | | | | | (37) |
| Cancellation of restricted stock | | (90) | 90 | | | | | |
| Proceeds from stock offering | 18 | 52,071 | | | | | | 52,089 |
| Purchase of treasury stock | | | | | | | (17,953) | (17,953) |
| Amortization of restricted stock | | | 654 | | | | | 654 |
| BALANCES AT NOVEMBER 2, 2002 | \$ 134 | \$ 156,889 | \$ (2,152) | \$ (806) | \$ 55,076 | | \$ (23,476) | \$ 185,665 |

See accompanying notes to consolidated financial statements.

GART SPORTS COMPANY
AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, Dollars in Thousands)

| | Thirty-nine weeks ended | |
|---|-------------------------|---------------------|
| | November 2, 2002 | November 3, 2001 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 10,321 | \$ 604 |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation and amortization | 17,693 | 14,685 |
| Deferred income taxes | 6,547 | 412 |
| Loss on disposition of assets | 417 | 385 |
| Increase in deferred rent | 2,125 | (3,488) |
| Deferred compensation | 25 | 69 |

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Thirty-nine weeks ended

| | <u>Thirty-nine weeks ended</u> | |
|---|--------------------------------|-------------------|
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (2,579) | (4,783) |
| Inventories | (90,134) | (101,931) |
| Prepaid expenses and other assets | (1,624) | (1,166) |
| Other assets | (278) | (3,033) |
| Accounts payable | 40,713 | 86,002 |
| Accrued expenses and other current liabilities | (7,406) | (8,477) |
| | <u> </u> | <u> </u> |
| Net cash used in operating activities | (24,180) | (20,721) |
| | <u> </u> | <u> </u> |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (19,357) | (17,990) |
| Proceeds from sale of property and equipment | | 7,834 |
| Sale of marketable securities | | 300 |
| Receipts of notes receivable | 36 | 229 |
| Acquisition of Oshman's, net of cash acquired | | (49,538) |
| | <u> </u> | <u> </u> |
| Net cash used in investing activities | (19,321) | (59,165) |
| | <u> </u> | <u> </u> |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from long-term debt | 258,305 | 266,846 |
| Principal payments on long-term debt | (252,121) | (180,483) |
| Principal payments on capital lease obligations | (486) | (287) |
| Proceeds from stock offering, net of offering costs | 52,089 | |
| Purchase of treasury stock | (17,953) | (3,110) |
| Proceeds from the sale of common stock under option plans | 2,662 | 1,670 |
| | <u> </u> | <u> </u> |
| Net cash provided by financing activities | 42,496 | 84,636 |
| | <u> </u> | <u> </u> |
| Increase (decrease) in cash and cash equivalents | (1,005) | 4,750 |
| Cash and cash equivalents at beginning of period | 11,536 | 8,107 |
| | <u> </u> | <u> </u> |
| Cash and cash equivalents at end of period | \$ 10,531 | \$ 12,857 |
| | <u> </u> | <u> </u> |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for interest, net | \$ 6,399 | \$ 7,406 |
| | <u> </u> | <u> </u> |
| Cash paid during the period for income taxes | \$ 1,423 | \$ 153 |
| | <u> </u> | <u> </u> |

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

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The accompanying unaudited consolidated financial statements do not include all information and footnotes necessary for the annual presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America, and should be read in conjunction with the 2001 Annual Report on Form 10-K. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the statement of financial position and the results of operations for the interim periods have been included. The results for the thirteen and thirty-nine week periods ended November 2, 2002 are not necessarily indicative of the results to be expected for the full year.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

2. ACQUISITION

On June 7, 2001, Gart Sports Company completed its acquisition of Oshman's Sporting Goods, Inc. ("Oshman's"). The consideration consisted of approximately 3.4 million shares of Gart Sports Company common stock valued at approximately \$37.8 million and approximately \$50.2 million in cash. Oshman's operates as a wholly owned subsidiary of the Company. At the time of the acquisition, Oshman's operated 58 sporting goods specialty stores, including 43 SuperSports USA stores and 15 traditional stores. The acquisition was accounted for under the purchase method of accounting, and accordingly, the statement of operations includes the results of Oshman's since the date of the acquisition.

The total cost of the acquisition has been allocated to the tangible and intangible assets acquired and liabilities assumed based on their respective fair values. The Company's initial recording of the purchase price has been adjusted to give effect to the market value of the Company stock at the time of the announcement of the merger and for changes in estimates made at the time of the initial recording. In compliance with Financial Accounting Standards Board ("FASB") Statement No. 142, the Company no longer amortizes goodwill. The final adjusted allocation of the purchase price is as follows:

| | |
|---|-----------|
| Inventory | \$ 67,336 |
| Other current assets | 19,415 |
| Property and equipment, net | 22,833 |
| Favorable leases and other long term assets, excluding goodwill | 13,953 |
| Goodwill | 45,310 |
| Current liabilities | (67,232) |
| Long term debt | (12,128) |
| Other long term liabilities | (1,463) |
| | 88,024 |
| Book value of net assets acquired, including intangibles | \$ 88,024 |

The following unaudited pro forma combined financial information presents the combined consolidated results of operations of Gart Sports Company and Oshman's as if the acquisition had occurred as of the beginning of fiscal 2001, after giving effect to certain adjustments, including amortization of favorable leases and goodwill, interest expense, depreciation expense, and related income tax effects. No adjustments have been made to the pro forma statement of operations to conform accounting policies and practices or to recognize anticipated cost savings and synergies. The

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pro forma combined consolidated financial information does not necessarily reflect the results of operations that would have occurred had Gart Sports Company and Oshman's constituted a single entity during such periods.

| | 39 weeks ended November 3, 2001 |
|---|--|
| (Unaudited, in thousands except per share amounts) | |
| Net Sales | 721,194 |
| Net Loss | (5,756)(1)(2) |

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| | 39 weeks ended November 3, 2001 |
|----------------------------------|--|
| Basic and diluted loss per share | (0.53)(1)(2) |

- (1) Includes \$7.1 million, before taxes, of integration costs, due to the acquisition of Oshman's.
- (2) Includes \$5.2 million, before taxes, of severance expense accrued by Oshman's as part of the acquisition.

3. NEW ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations consummated after June 30, 2001 and establishes criteria for recognizing intangible assets separately from goodwill.

SFAS No. 142 requires that upon adoption, amortization of goodwill and intangible assets deemed to have indefinite lives will cease and instead, the carrying value of goodwill and these intangibles will be evaluated for impairment on an annual basis. In addition, a transitional impairment test is required as of the date of adoption. Other intangible assets will continue to be amortized over their useful lives and periodically reviewed for impairment. The Company adopted SFAS No. 142 for the period commencing February 3, 2002, the beginning of its fiscal 2002. The Company completed its initial impairment analysis of its existing goodwill in the first quarter of fiscal 2002, and determined that no impairment was indicated.

The adoption of SFAS No. 142 did not have a material impact on the Company's consolidated financial position, results of operations, or cash flows in regard to the impairment provisions of the statement while the application of the non-amortization provisions of the statement will result in the cessation of amortization of approximately \$1.1 million per year.

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Net income (loss) and earnings (loss) per share for the thirteen and thirty-nine weeks ended November 3, 2001 adjusted to exclude amortization expense (net of income taxes) is as follows (in thousands, except per share data):

| | 13 weeks ended November 3, 2001 | 39 weeks ended November 3, 2001 |
|--|--|--|
| Reported net income (loss) | \$ (1,896) | \$ 604 |
| Add back goodwill amortization, net of tax | 229 | 381 |
| Adjusted net income (loss) | \$ (1,667) | \$ 985 |
| Basic earnings (loss) per share: | | |
| Reported net income (loss) | \$ (0.18) | \$ 0.07 |
| Add back goodwill amortization, net of tax | 0.02 | 0.04 |

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| | 13 weeks ended November 3, 2001 | 39 weeks ended November 3, 2001 |
|--|--|--|
| Adjusted net income (loss) | \$ (0.16) | \$ 0.11 |
| Diluted earnings per (loss) share: | | |
| Reported net income (loss) | \$ (0.18) | \$ 0.06 |
| Add back goodwill amortization, net of tax | 0.02 | 0.04 |
| Adjusted net income (loss) | \$ (0.16) | \$ 0.10 |

The carrying amount of intangible assets is as follows (in thousands):

| | As of November 2, 2002 | |
|-------------------------|--------------------------|-----------------------------|
| | Gross Carrying Amount | Accumulated Amortization |
| Goodwill | \$ 45,310 | \$ (734) |
| Favorable leases | 14,080 | (2,574) |
| Loan origination fees | 4,043 | (2,191) |
| Lease acquisition costs | 3,268 | (613) |
| Total | \$ 66,701 | \$ (6,112) |

The Company recorded an additional \$3.3 million of goodwill in the 26 weeks ended August 3, 2002 as a result of certain adjustments related to the purchase accounting for the acquisition of Oshman's. During the three months ended November 2, 2002, amortization of intangible assets expense was \$0.8 million. The estimated amortization of intangible assets for each of the five fiscal years ending in fiscal 2006 is as follows (in thousands):

| Fiscal Year | Amortization Expense |
|-------------|-------------------------|
| 2002 | \$ 3,148 |
| 2003 | \$ 2,825 |
| 2004 | \$ 2,462 |
| 2005 | \$ 1,723 |
| 2006 | \$ 1,259 |

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses certain implementation issues related to SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" and establishes a single accounting model, based on the framework established in SFAS No. 121, for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. The Company adopted this statement on February 3, 2002 and there was not a material impact on results of operations or financial position.

In May 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, 64, Amendment of SFAS No. 13, and Technical Corrections." SFAS No. 145 rescinds FASB No. 4, "Reporting Gains and Losses from Extinguishment of Debt," and an amendment of that statement, SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." As a result, gains and losses from extinguishment of debt will no longer be aggregated and classified as an extraordinary item, net of related income tax effect, on the statement of earnings. SFAS No. 145 is effective for fiscal years beginning after May 15, 2002, with earlier application encouraged.

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In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS 146 requires that a liability for a cost associated with an exit or disposal activity is recognized at fair value when the liability is incurred rather than at the date of a commitment to an exit or disposal plan. This statement is effective for exit or disposal activities initiated after December 31, 2002.

4. SHARE REPURCHASE PROGRAM

The Company repurchased 501,400 common shares totaling approximately \$8.6 million during the quarter ended November 2, 2002 under a common share repurchase program approved by the Board of Directors. In the nine months ended November 2, 2002, the Company repurchased 961,399 common shares totaling approximately \$18.0 million. As of November 19, 2002, the Company has authorization from its Board of Directors to repurchase up to an additional \$9.0 million of shares.

5. EARNINGS (LOSS) PER SHARE

The following table sets forth the computations of basic and diluted earnings (loss) per share (in thousands, except share and per share amounts):

| | Thirteen weeks ended | | Thirty-nine weeks ended | |
|---|----------------------|---------------------|-------------------------|---------------------|
| | November 2, 2002 | November 3, 2001 | November 2, 2002 | November 3, 2001 |
| Net income (loss) | \$ 1,397 | \$ (1,896) | \$ 10,321 | \$ 604 |
| Weighted average shares of common stock outstanding basic | 12,076,645 | 10,803,273 | 11,734,135 | 9,232,749 |
| Basic earnings (loss) per share | \$ 0.12 | \$ (0.18) | \$ 0.88 | \$ 0.07 |
| Number of shares used for diluted earnings per share: | | | | |
| Weighted average shares of common stock outstanding basic | 12,076,645 | 10,803,273 | 11,734,135 | 9,232,749 |
| Dilutive securities stock options and unvested restricted stock | 678,704 | | 829,714 | 680,353 |
| Weighted average shares of common stock outstanding diluted | 12,755,349 | 10,803,273 | 12,563,849 | 9,913,102 |
| Diluted earnings (loss) per share | \$ 0.11 | \$ (0.18) | \$ 0.82 | \$ 0.06 |

6. CONTINGENCIES

Tax Contingency

Under the terms of the Company's tax sharing agreement with its former parent, the Company is responsible for its share, on a separate return basis, of any tax payments associated with proposed deficiencies or adjustments, and related interest and penalties charged to the controlled group which may arise as a result of an assessment by the IRS.

On July 24, 1997, the IRS proposed adjustments to the Company's and its former parent's (now Thrifty Payless Holdings, Inc., a subsidiary of RiteAid Corporation) 1992 and 1993 federal income tax returns in conjunction with the former parent's Internal Revenue Service examination. The proposed adjustments related to the manner in which LIFO inventories were characterized on such returns. The Company has taken the position that the inventory acquired in connection with the acquisition of the Company's former parent was appropriately allocated to its inventory pools. The Internal Revenue Service asserted the inventory was acquired at a bargain purchase price and should be allocated to a separate pool and liquidated as inventory turns.

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On November 1, 2002, in order to eliminate the accrual of additional interest on taxes owed to the IRS, the Company entered into an agreement with the IRS, based upon the terms of the settlement that is currently pending between the IRS and the Company's former parent. Pursuant to the agreement, the Company paid the IRS taxes of \$1.1 million and interest of \$0.5 million. As such, the Company recorded a reversal of its remaining accrued interest payable to the IRS, totaling approximately \$0.7 million. The tax liability settled under the agreement was recorded as a reduction of the long-term deferred tax liability that had been established previously in relation to this matter. A significant portion of the tax liability agreed to by the Company under the agreement did not require cash payment as those adjustments reduced existing net operating losses previously generated by the Company. The Company believes this to be a full and complete settlement of all its separate return issues under review by the IRS, with respect to the Company's inclusion in its former parent's (now Thrifty Payless Holdings, Inc., a subsidiary of RiteAid Corporation) 1992 and 1993 federal income tax returns.

The IRS settlement with the Company's former parent has not been finalized. Under the terms of the Company's tax sharing agreement with its former parent, the Company could be liable for amounts that arise out of the Company's former parent's settlement with the IRS. Based on management's discussions with the Company's former parent and the Company's settlement that was reached with the IRS as described above, the Company believes its portion of the potential accelerated tax liability from the settlement with the IRS by the Company's former parent ranges from approximately \$0 to \$3.3 million. As previously disclosed, the Company had a long-term deferred tax liability of \$9.7 million recorded for the settlement of this matter with both the IRS and the Company's former parent. As a result of the Company's settlement reached with the IRS, the remaining liability has been reduced to \$3.3 million. The Company does not expect that any penalties will be assessed relating to this matter although the Company cannot be certain that penalties will not be assessed.

The Company has reviewed the various matters that are under consideration and believes that it has adequately provided for any liability that may result from this matter. In the opinion of management, any additional liability beyond the amounts recorded that may arise as a result of the pending IRS settlement with its former parent will not have a material adverse effect on the Company's consolidated financial condition, results of operations, or liquidity.

Legal Proceedings

The Company is, from time to time, involved in various legal proceedings and claims arising in the ordinary course of business. Management believes that the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial condition, results of operations or liquidity.

In June 2000, a former employee of Sportmart brought two class action complaints in California against the Company, alleging certain wage and hour claims in violation of the California Labor Code, California Business and Professional Code section 17200 and other related matters. One complaint alleges that the Company classified certain managers in its California stores as exempt from overtime pay when they would have been classified as non-exempt and paid overtime. The second complaint

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alleges that the Company failed to pay hourly employees in its California stores for all hours worked. In March 2001, a third class action complaint was filed in the same court in California alleging the same wage and hour violations regarding classification of certain managers as exempt from overtime pay. In July 2001, a fourth complaint was filed alleging that store managers should also not be classified as employees exempt from overtime pay. All the complaints seek compensatory damages, punitive damages and penalties. The amount of damages sought is unspecified. Although the court denied motions to dismiss the first two complaints, the Company intends to vigorously defend these matters and at this time, the Company has not ascertained the future liability, if any, as a result of these complaints. The Company has not accrued any reserves related to these claims.

7. FINANCIAL INSTRUMENTS

Interest Rate Swap

The Company entered into an interest rate swap agreement on June 28, 2001, which expires on June 30, 2004, to minimize the risks and costs associated with its financing activities. Under the swap agreement, the Company pays fixed rate interest and receives variable LIBOR interest rate payments periodically over the life of the instrument. The notional interest rate swap amount is \$20.0 million and is used to measure interest to be paid or received and does not represent the exposure due to credit loss.

The Company's interest rate swap is designated as a cash flow hedge, qualifies for the short cut method of assessing effectiveness and is considered highly effective, as defined by FASB Statement No. 133. Under the short cut method there is no need to measure effectiveness of the hedge and there is no charge to earnings for changes in the fair value of the swap agreement. Payments or receipts on the swap agreement are

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recorded as interest expense. At November 2, 2002 the fair value of the swap, net of the related tax benefit, was a loss of \$739,000. The unrealized loss from this interest rate swap is included in other comprehensive income and is shown as a component of stockholders' equity.

8. E-COMMERCE AGREEMENT

On June 28, 2001, the Company entered into a long-term agreement with GSI Commerce, Inc. ("GSIC"), formerly Global Sports Interactive, Inc. Under the terms of the agreement, GSIC developed and is currently operating three online sporting goods stores at www.gartsports.com, www.sportmart.com, and www.oshmans.com. The Company receives royalty payments from GSIC based on a certain percent of sales from these sites, which are recorded as a component of Net Sales in the statement of operations. In connection with the e-commerce agreement, GSIC granted the Company a warrant to purchase 60,000 shares of common stock of GSIC. A similar warrant for 30,000 GSIC shares was acquired from Oshman's at the time of the acquisition. The Company sold 60,000 of these warrants in October 2001, and recognized a gain of \$195,000. The remaining warrant to purchase 30,000 shares was exercised on November 2, 2001, and the shares acquired upon exercise of the warrant are classified as available-for-sale marketable equity securities and have an aggregate fair value of \$91,000 at November 2, 2002.

9. STOCK OFFERING

On May 29, 2002, the Company completed a stock offering for 3.5 million shares of common stock. This offering resulted in net proceeds of approximately \$53 million from the sale of 1.75 million new shares by the Company. The Company used the net proceeds to repay certain borrowings under the revolving line of credit agreement with CIT Group/Business Credit, Inc. The balance of the shares were sold by selling stockholders, including Green Equity Investors, L.P. The Company did not receive any proceeds from the sale of shares by selling stockholders.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with the Company's consolidated financial statements and notes thereto included elsewhere within this report and the 2001 Annual Report on Form 10-K.

The Company is a leading retailer of sporting goods in the Midwest and western United States. Given the economic characteristics of the store formats, the similar nature of the products sold, the type of customer and method of distribution, the operations of the Company are aggregated in one reportable segment.

The Company uses a 52-53 week fiscal reporting year ending on the Saturday closest to the end of January, which for fiscal year 2002 will be February 1, 2003. The results include the results of Oshman's from June 7, 2001, the date of acquisition.

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RESULTS OF OPERATIONS

The following table sets forth the Company's consolidated statement of operations data as a percentage of net sales and the number of stores open at the end of each period for the periods indicated (dollars rounded to millions, except share and per share amounts):

| | Thirteen weeks ended | | | | Thirty-nine weeks ended | | | |
|--|----------------------|--------|------------------|--------|-------------------------|--------|------------------|--------|
| | November 2, 2002 | | November 3, 2001 | | November 2, 2002 | | November 3, 2001 | |
| | Dollars | % | Dollars | % | Dollars | % | Dollars | % |
| Net sales | \$ 227.7 | 100.0% | \$ 219.1 | 100.0% | \$ 734.4 | 100.0% | \$ 619.7 | 100.0% |
| Cost of goods sold, buying, distribution and occupancy | (170.8) | (75.0) | (164.7) | (75.2) | (547.9) | (74.6) | (466.6) | (75.3) |

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| | Thirteen weeks ended | | | | Thirty-nine weeks ended | | | |
|--|----------------------|--------|------------|--------|-------------------------|--------|-----------|--------|
| Gross profit | 56.9 | 25.0 | 54.4 | 24.8 | 186.5 | 25.4 | 153.1 | 24.7 |
| Operating expenses | (53.3) | (23.4) | (52.3) | (23.9) | (163.6) | (22.3) | (139.2) | (22.5) |
| Merger integration costs | | 0.0 | (3.6) | (1.6) | | 0.0 | (7.1) | (1.1) |
| Operating income (loss) | 3.6 | 1.6 | (1.5) | (0.7) | 22.9 | 3.1 | 6.8 | 1.1 |
| Interest expense, net | (1.5) | (0.7) | (2.6) | (1.2) | (6.7) | (0.9) | (7.3) | (1.2) |
| Other income | 0.2 | 0.0 | 1.0 | 0.5 | 0.6 | 0.1 | 1.5 | 0.2 |
| Income (loss) before income taxes | 2.3 | 1.0 | (3.1) | (1.4) | 16.8 | 2.3 | 1.0 | 0.2 |
| Income tax (expense) benefit | (0.9) | (0.4) | 1.2 | 0.5 | (6.5) | (0.9) | (0.4) | (0.1) |
| Net income (loss) | \$ 1.4 | 0.6% | \$ (1.9) | (0.9)% | \$ 10.3 | 1.4% | \$ 0.6 | 0.1% |
| Basic earnings (loss) per share | \$ 0.12 | | \$ (0.18) | | \$ 0.88 | | \$ 0.07 | |
| Diluted earnings (loss) per share | \$ 0.11 | | \$ (0.18) | | \$ 0.82 | | \$ 0.06 | |
| Basic weighted average shares outstanding | 12,076,645 | | 10,803,273 | | 11,734,135 | | 9,232,749 | |
| Diluted weighted average shares outstanding | 12,755,349 | | 10,803,273 | | 12,563,849 | | 9,913,102 | |
| Number of stores at end of period | 180 | | 177 | | 180 | | 177 | |
| Pro-forma FY 2001 results excluding the effect of the one time integration costs associated with the acquisition of Oshman's: | | | | | | | | |
| Income (loss) before income taxes as reported | | | \$ (3.1) | (1.4) | | | \$ 1.0 | 0.2 |
| Integration costs | | | 3.6 | 1.6 | | | 7.1 | 1.1 |
| Pro-forma income before income taxes | | | 0.5 | 0.2 | | | 8.1 | 1.3 |
| Income tax expense | | | (0.2) | (0.1) | | | (3.2) | (0.5) |
| Pro-forma net income | | | \$ 0.3 | 0.1 | | | \$ 4.9 | 0.8 |
| Earnings per share: | | | | | | | | |
| Basic | | | \$ 0.03 | | | | \$ 0.53 | |
| Diluted | | | \$ 0.03 | | | | \$ 0.50 | |
| Basic weighted average shares outstanding | | | 10,803,273 | | | | 9,232,749 | |
| Diluted weighted average shares outstanding | | | 11,450,548 | | | | 9,913,102 | |

Newly opened stores enter the comparable store sales base at the beginning of their 14th full month of operation. The Oshman's stores, that met the criteria above, were included in the comparable store sales base beginning August 4, 2002, the beginning of the 14th full month of operations since the date of acquisition by the Company.

Inventories are stated at the lower of LIFO cost or market. The Company considers cost of goods sold to include the direct cost of merchandise, plus certain costs associated with procurement, warehousing, handling and distribution. In addition to the full cost of inventory,

cost of goods sold includes related occupancy costs and amortization and depreciation of leasehold improvements and rental equipment. Operating expenses include controllable and non-controllable store expenses (except

occupancy), non-store expenses and depreciation and amortization not associated with cost of goods sold.

CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis discusses the results of operations and financial condition as reflected in the Company's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 reported amounts of revenues and expenses during the reporting period. On an ongoing basis, management evaluates its estimates and judgments, including those related to inventory valuation, the recoverability of long-lived assets including intangible assets, the store closing reserve, and the estimates used to record purchase accounting related to acquisitions. Management bases its estimates and judgments on its substantial historical experience and other relevant factors, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

Valuation of Inventory

The Company values its inventory at the lower of cost or market. Cost is determined using the average cost of items purchased and applying the dollar value last-in, first-out ("LIFO") inventory method. The Company's dollar value LIFO pools are computed using the Inventory Price Index Computation ("IPIC") method. Historically, we have rarely experienced significant occurrences of obsolescence or slow moving inventory. However, future changes, such as changes in customer merchandise preferences or unseasonable weather patterns could cause the Company's inventory to be exposed to obsolescence or slow moving merchandise.

Shrink is accrued as a percentage of merchandise sales based on historical shrink trends. We perform physical inventories at our stores and distribution centers throughout the year. The reserve for shrink represents an estimate for shrink for each of our locations since the last physical inventory date through the reporting date. These estimates are impacted by internal and external factors and may vary from actual results.

Vendor allowances

We receive certain allowances from our vendors, which include rebates and cooperative advertising funds. These amounts are determined in advance for each year and are, at times, dependent on projected purchase volumes and advertising plans. The amounts are subject to changes in market conditions or marketing strategies of our vendors, and changes in our product purchases. We record an estimate of earned allowances based on the latest information available with respect to purchase volumes, advertising plans and status of our negotiations with vendors.

Impairment of Assets

The Company reviews long-lived tangible and intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be fully recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the

carrying amount or fair value less costs to sell. Future events could cause management to conclude that impairment indicators exist and that the value of long-lived tangible and intangible assets is impaired.

Store Closing Reserve

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The Company currently records a provision for store closing when the decision to close a store is made. The provision consists of the incremental costs which are expected to be incurred after the store closing, including settlement of future net lease obligations, utilities and property taxes, and other expenses directly related to the store closing. The Company will comply with the recently issued SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities" beginning January 1, 2003, which requires that a liability for costs associated with exit or disposal activities initiated after December 31, 2002, be recognized at fair value when a liability is incurred rather than when the decision to close a store is made. This will change the timing of recognition for certain exit costs, so that certain exit costs will be recognized over the period in which the exit activities occur.

Acquisitions Accounting

The Company's acquisitions are accounted for under the purchase method of accounting. Accordingly, the total costs of the acquisitions are allocated to the tangible and intangible assets acquired and liabilities assumed based on their respective fair values. The determination of fair values involves the use of estimates and assumptions which could require adjustment in the future.

While the Company believes that the historical experience and other factors considered provide a meaningful basis for the accounting policies applied in the preparation of the consolidated financial statements, the Company cannot guarantee that its estimates and assumptions will be accurate, which could require the Company to make adjustments to these estimates in future periods.

THIRTEEN WEEKS ENDED NOVEMBER 2, 2002 COMPARED TO THIRTEEN WEEKS ENDED NOVEMBER 3, 2001

Net Sales. Net sales for the thirteen weeks ended November 2, 2002 were \$227.8 million compared to \$219.1 million for the thirteen weeks ended November 3, 2001. Comparable store sales during the quarter increased by 1.5% versus the prior year's comparable quarter. Although positive, this comparable sales performance was negatively impacted by the continued uncertain economy and overall weak retail environment. In addition, several other external factors impacted sales negatively during the quarter. The effects of the drought and forest fire activity in the Rocky Mountain Region and the Western United States fueled decreases in the camping and hunting departments. Sales of in-line skates decreased from the year ago period primarily due to less promotional events related to skates this year versus last and an overall downward trend in the popularity of the category. These decreases were more than offset by increases in the following categories: licensed apparel, ski softgoods, exercise equipment, outdoor apparel, and denim apparel. Licensed apparel sales increased primarily as a result of teams in our markets being involved in the Major League Baseball World Series and Playoffs. Ski softgoods and outdoor apparel were positively impacted by cooler weather and measurable snowfall in many of our markets during the last half of the quarter. Exercise equipment increased versus the year ago period primarily due to increased popularity of exercising at home as well as improved inventory positions. Denim apparel sales increased, as this is a new product line this year.

Gross Profit. Gross profit for the thirteen weeks ended November 2, 2002 was \$57.0 million, or 25.0% of net sales, as compared to \$54.4 million, or 24.8% of net sales, for the thirteen weeks ended November 3, 2001. The increase as a percent of sales is due to a number of factors including: a less promotional strategy taken during the quarter; synergies being realized from the Oshman's acquisition; favorable shrink results from physical inventories taken during the period; continued systems

improvements, allowing the Company to better manage in-stock positions, and the addition of key personnel in the buying organization, particularly in the softlines department.

Operating Expenses. Operating expenses for the thirteen weeks ended November 2, 2002 were \$53.3 million, or 23.4% of net sales, compared to \$52.3 million, or 23.9% of net sales, for the period ended November 3, 2001. Operating expense dollars increased primarily due to increased insurance costs and corporate occupancy costs. As a percentage of sales, operating expenses decreased compared to the prior year quarter primarily due to decreased advertising costs as well as a continued focus on controlling all costs.

Merger Integration Costs. Merger integration costs for the thirteen weeks ended November 2, 2002 were \$0 compared to \$3.6 million, or 1.6% of net sales, for the period ended November 3, 2001. The Company has not recorded any merger integration costs since the fourth quarter of fiscal 2001.

Operating Income. As a result of the factors described above, the Company recorded operating income for the thirteen weeks ended November 2, 2002 of \$3.6 million compared to an operating loss of \$1.5 million for the thirteen weeks ended November 3, 2001.

Interest Expense. Interest expense, net for the thirteen weeks ended November 2, 2002 decreased to \$1.5 million, or 0.7% of net sales, from \$2.6 million, or 1.2% of net sales, in the thirteen weeks ended November 3, 2001. The decrease in interest expense is related to lower

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effective borrowing rates on amounts borrowed, a settlement with the IRS (see note 6 to the consolidated financial statements), and lower average debt as a net result of the proceeds from the common stock offering and the offsetting impact of borrowings for the shares repurchased under the 2002 common share repurchase program.

Other Income. Other income was \$0.2 million for the thirteen weeks ended November 2, 2002 compared to \$1.0 million for the thirteen weeks ended November 2, 2001. The decrease is primarily attributable to non-recurring items recorded in the prior year quarter, including \$0.5 million of income related to a consulting services agreement and \$0.2 million of income recognized on the sales of marketable securities.

Income Taxes. The Company's income tax expense for the thirteen weeks ended November 2, 2002 was \$0.9 million compared to an income tax benefit of \$1.2 million for the thirteen weeks ended November 3, 2001. The Company's estimated effective tax rate was 39.5% for the thirteen weeks ended November 2, 2002 compared to 39.0% for the thirteen weeks ended November 3, 2001.

THIRTY-NINE WEEKS ENDED NOVEMBER 2, 2002 COMPARED TO THIRTY-NINE WEEKS ENDED NOVEMBER 3, 2001

Net Sales. Net sales for the thirty-nine weeks ended November 2, 2002 were \$734.4 million compared to \$619.7 million for the thirty-nine weeks ended November 3, 2001. Last year's sales only include Oshman's results after the June 7, 2001 acquisition date. Comparable store sales, which includes the Oshman's stores since August 4, 2002, increased 1.8%. This comparable sales performance was primarily due to strong comparative sales in the first quarter in apparel and hardgoods and a return to seasonal weather late in the third quarter. This performance was tempered by the overall challenging sales environment, due in part to unseasonable weather conditions for much of the period and an overall weak retail environment fueled by the uncertain economy as a whole, especially in the second and third quarters.

Gross Profit. Gross profit for the thirty-nine weeks ended November 2, 2002 was \$186.5 million, or 25.4% of net sales, as compared to \$153.1 million, or 24.7% of net sales, for the thirty-nine weeks ended November 3, 2001. The increase as a percent of sales is due to a number of factors including: a less promotional strategy taken during the period; synergies being realized from the Oshman's

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acquisition; favorable shrink results; systems investments, allowing the Company to better manage in-stock positions, and the addition of key personnel in the buying organization, particularly in the softlines department.

Operating Expenses. Operating expenses for the thirty-nine weeks ended November 2, 2002 were \$163.6 million, or 22.3% of net sales, compared to \$139.2 million, or 22.5% of net sales, for the period ended November 3, 2001. Operating expense dollars increased primarily due to the Oshman's acquisition versus the same period last year. As a percentage of sales, operating expenses decreased slightly primarily due to decreased advertising costs as well as continued focus on controlling all costs.

Merger Integration Costs. Merger integration costs for the thirty-nine weeks ended November 2, 2002 were \$0 compared to \$7.1 million, or 1.1% of net sales, for the period ended November 3, 2001. The Company has not recorded any merger integration costs since the fourth quarter of fiscal 2001.

Operating Income. As a result of the factors described above, the Company recorded operating income for the thirty-nine weeks ended November 2, 2002 of \$22.9 million compared to operating income of \$6.8 million for the thirty-nine weeks ended November 3, 2001.

Interest Expense. Interest expense, net for the thirty-nine weeks ended November 2, 2002 decreased to \$6.7 million, or 0.9% of net sales, from \$7.3 million, or 1.2% of net sales, in the thirty-nine weeks ended November 3, 2001. The decrease in interest expense is related to lower effective borrowing rates on amounts borrowed in 2002, a settlement with the IRS in the third quarter of 2002 (see note 6 to the consolidated financial statements), lower average debt as a net result of the proceeds from the May 2002 common stock offering, and the offsetting impact of a higher average debt balance due to the acquisition of Oshman's on June 7, 2001 and the shares repurchased under the 2002 common share repurchase program.

Other Income. Other income was \$0.6 million for the thirty-nine weeks ended November 2, 2002 compared to \$1.5 million for the thirty-nine weeks ended November 3, 2001. The decrease is primarily attributable to non-recurring items recorded in the prior year, including \$0.5 million of income related to a consulting services agreement, \$0.2 million of income recognized on the sales of marketable securities, and a one-time gain of \$0.2 million on the sale of certain assets that were held in Edmonton, Alberta, Canada. These were slightly offset by increased sales tax handling income in the current year, due to increased sales volume as a result of the acquisition of Oshman's.

Income Taxes. The Company's income tax expense for the thirty-nine weeks ended November 2, 2002 was \$6.5 million compared to income tax expense of \$0.4 million for the thirty-nine weeks ended November 3, 2001. The Company's estimated effective tax rate was 38.8%

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for the thirty-nine weeks ended November 2, 2002 compared to 38.9% for the thirty-nine weeks ended November 3, 2001.

LIQUIDITY AND CAPITAL RESOURCES

The Company's primary capital requirements are for inventory, capital improvements, and pre-opening expenses to support the Company's expansion plans, as well as for various investments in store remodeling, store fixtures, ongoing infrastructure improvements and the company's current stock repurchase program.

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Cash Flow Analysis

| | Thirty-nine weeks ended | |
|---------------------------------------|-------------------------|---------------------|
| | November 2, 2002 | November 3, 2001 |
| Cash used in operating activities | \$ (24,180) | \$ (20,721) |
| Cash used in investing activities | (19,321) | (59,165) |
| Cash provided by financing activities | 42,496 | 84,636 |
| Capital expenditures | 19,357 | 17,990 |
| | As of | |
| | November 2, 2002 | November 3, 2001 |
| Long-term debt | \$ 164,658 | \$ 193,786 |
| Working capital | 203,950 | 172,363 |
| Current ratio | 1.77 | 1.61 |
| Debt to equity ratio | 0.89 | 1.31 |

Cash used in operating activities in the first nine months of fiscal 2002 was primarily the result of inventory purchases. Cash used was partially offset by increases in accounts payable and cash generated by net income adjusted for non-cash charges during the period.

Cash used in investing activities for the thirty-nine weeks ended November 2, 2002 was primarily for capital expenditures. These expenditures were primarily for new stores, store remodeling, store fixtures, and the purchase or enhancement of certain information systems.

Cash provided by financing activities in the first nine months of fiscal 2002 primarily represents proceeds from the secondary stock offering and proceeds from net borrowings on the Company's line of credit, offset by payments made in connection with the Company's stock repurchase program.

The Company's liquidity and capital needs have been met by cash from operations and borrowings under a revolving line of credit (the "Credit Agreement") with CIT/Business Credit, Inc., as agent, ("CIT"). In connection with the Oshman's acquisition, the Company increased its revolving line of credit from \$175 million to \$300 million. The long-term debt currently consists of the Credit Agreement, which allows the Company to borrow up to 70% of its eligible inventories (as defined in the Credit Agreement) during the year. Borrowings are limited to the lesser of \$300 million or the amount calculated in accordance with the borrowing base, and are secured by substantially all inventories, trade receivables, equipment, and intangible assets. The lenders may not demand repayment of principal, absent an occurrence of default under the Credit Agreement, prior to June 7, 2005. The Credit Agreement contains certain covenants, including financial covenants that require the Company to maintain a specified minimum level of tangible net worth at all times and specified earnings before interest, taxes, depreciation and amortization to interest ratios. Gart Sports Company's ability to declare or pay dividends on its common stock is not limited under the revolving line of credit. The revolving line of credit does, however, limit the amount of dividends that may be declared or paid on the common stock of its subsidiaries and the amount of loans that may be made to Gart Sports Company. The subsidiaries may loan its parent up to \$10.0 million in the aggregate and declare up to \$6.0 million in dividends each fiscal year. The Company is in compliance with all covenants under the Credit Agreement. In connection with the Credit Agreement, the Company pledged all of the outstanding common stock of its operating retail subsidiaries as collateral for the Credit Agreement.

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Under the terms of the revolving credit facility, loan interest is payable monthly at Chase Manhattan Bank's prime rate plus a margin rate that cannot exceed 0.25% or, at the option of the Company, at Chase Manhattan Bank's LIBOR rate plus a margin that cannot exceed 2.25%. The

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Company's margin rates for the first loan year were 0.0% on prime and 2.0% on LIBOR borrowings. The margin rates on borrowings subsequent to June 7, 2002 have been 0.25% on prime and 2.25% and may be reduced to as low as 0.0% and 1.50%, respectively, on borrowings subsequent to November 3, 2002, if certain Earnings Before Interest, Taxes, Depreciation, and Amortization ("EBITDA") levels are achieved. There was \$164.7 million outstanding under the credit facility as of November 2, 2002, and \$107.3 million was available for borrowing. As a result of the stock offering discussed in note 9 to the consolidated financial statements, the Company paid down approximately \$53 million in debt by June 12, 2002.

On May 29, 2002, the Company completed a common stock offering for 3.5 million shares. This offering resulted in net proceeds of approximately \$53 million from the sale, by the Company, of 1.75 million shares.

The Company repurchased 501,400 common shares totaling approximately \$8.6 million during the quarter ended November 2, 2002 under a common share repurchase program approved by the Board of Directors. In the nine months ended November 2, 2002, the Company repurchased 961,399 common shares totaling approximately \$18.0 million. As of November 19, 2002, the Company has authorization from its Board of Directors to repurchase up to an additional \$9.0 million of shares.

The Company entered into an interest rate swap agreement on June 28, 2001 to minimize the risks and costs associated with its financing activities. The notional interest rate swap amount is \$20.0 million and the swap agreement terminates on June 30, 2004. Under the swap agreement, the Company pays fixed rate interest and receives variable interest rate payments periodically over the life of the instrument. See note 7 to the consolidated financial statements.

On July 24, 1997, the IRS proposed adjustments to the Company's and its former parent's (now Thrifty Payless Holdings, Inc., a subsidiary of RiteAid Corporation) 1992 and 1993 federal income tax returns in conjunction with the former parent's Internal Revenue Service examination. The proposed adjustments related to the manner in which LIFO inventories were characterized on such returns. On November 1, 2002, in order to eliminate the accrual of additional interest on taxes owed to the IRS, the Company entered into an agreement with the IRS, based upon the terms of the settlement that is currently pending between the IRS and the Company's former parent. Pursuant to the agreement, the Company paid the IRS taxes of \$1.1 million and interest of \$0.5 million. The Company believes this to be a full and complete settlement of all its separate return issues under review by the IRS, with respect to the Company's inclusion in its former parent's (now Thrifty Payless Holdings, Inc., a subsidiary of RiteAid Corporation) 1992 and 1993 federal income tax returns. The IRS settlement with the Company's former parent has not been finalized. Under the terms of the Company's tax sharing agreement with its former parent, the Company could be liable for amounts that arise out of the Company's former parent's settlement with the IRS. Based on management's discussions with the Company's former parent and the Company's settlement that was reached with the IRS as described above, the Company believes its portion of the potential accelerated tax liability from the settlement with the IRS by the Company's former parent ranges from approximately \$0 to \$3.3 million. The Company has a long term deferred tax liability of \$3.3 million recorded for the settlement of this matter. The Company does not expect that any penalties will be assessed relating to this matter although the Company cannot be certain that penalties will not be assessed. See note 6 to the consolidated financial statements.

Capital expenditures are projected to be approximately \$25 million in fiscal 2002. These capital expenditures will be primarily for new store openings, store remodeling, store fixtures, information systems, and, beginning in the fourth quarter, distribution center facilities. The Company leases all of its store locations and intends to continue to finance its new stores with long-term operating leases. Based upon stores opened in fiscal 2001, newly constructed superstores require a cash investment of approximately \$1.6 million for a 42,000 square foot store and approximately \$1.3 million for a 32,000

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square foot store. The Company opened eight new stores in fiscal 2002. The Company has spent approximately \$19.4 million on capital expenditures for the 39 weeks ended November 2, 2002.

The Company believes that cash generated from operations, combined with funds available under the Credit Agreement, will be sufficient to fund projected capital expenditures, future common share purchases, if any, and other working capital requirements for the foreseeable future.

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The Company intends to utilize the Credit Agreement to meet seasonal fluctuations in cash flow requirements.

SEASONALITY AND INFLATION

The fourth quarter has historically been the strongest quarter for the Company. The Company believes that two primary factors contribute to this seasonality. First, increased sales of cold weather sporting goods occurs, including sales of ski and snowboard merchandise during the quarter, which corresponds with much of the ski and snowboard season. Second, holiday sales contribute significantly to the Company's operating results. As a result of these factors, inventory levels, which gradually increase beginning in April, generally reach their peak in November and then decline to their lowest level following the December holiday season. Any decrease in sales for the fourth quarter, whether due to a slow holiday selling season, poor snowfall in ski areas near the Company's markets or otherwise, could have a material adverse effect on the Company's business, financial condition and operating results for the entire fiscal year.

Although the operations of the Company are influenced by general economic conditions, the Company does not believe that inflation has a material impact on the Company's results of operations. The Company believes that it is generally able to pass along any inflationary increases in costs to its customers.

NEW ACCOUNTING PRONOUNCEMENTS

In June 2001, the FASB issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations consummated after June 30, 2001 and establishes criteria for recognizing intangible assets separately from goodwill.

SFAS No. 142 requires that upon adoption, amortization of goodwill and intangible assets deemed to have indefinite lives will cease and instead, the carrying value of goodwill and these intangibles will be evaluated for impairment on an annual basis. In addition, a transitional impairment test is required as of the date of adoption. Other intangible assets will continue to be amortized over their useful lives and periodically reviewed for impairment. The Company adopted SFAS No. 142 for the period commencing February 3, 2002, the beginning of its fiscal 2002. The Company completed its initial impairment analysis of its existing goodwill in the first quarter of fiscal 2002, and determined that no impairment was indicated. The adoption of SFAS No. 142 did not have a material impact on the Company's consolidated financial position, results of operations, or cash flows in regard to the impairment provisions of the statement while the application of the non-amortization provisions of the statement will result in the cessation of amortization of approximately \$1.1 million per year.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses certain implementation issues related to SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" and establishes a single accounting model, based on the framework established in SFAS No. 121, for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. The Company adopted this statement on February 3, 2002, and there was not a material impact on results of operations or financial position.

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In May 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, 64, Amendment of SFAS No. 13, and Technical Corrections." SFAS No. 145 rescinds FASB No. 4, "Reporting Gains and Losses from Extinguishment of Debt," and an amendment of that statement, SFAS No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements." As a result, gains and losses from extinguishment of debt will no longer be aggregated and classified as an extraordinary item, net of related income tax effect, on the statement of earnings. SFAS No. 145 is effective for fiscal years beginning after May 15, 2002, with earlier application encouraged.

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS 146 requires that a liability for a cost associated with an exit or disposal activity is recognized at fair value when the liability is incurred rather than at the date of a commitment to an exit or disposal plan. This statement is effective for exit or disposal activities initiated after December 31, 2002.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company's primary interest rate risk exposure results from the Company's long-term debt agreement. The Company's long-term debt bears interest at variable rates that are tied to either the U.S. prime rate or LIBOR at the time of the borrowing. The Company maintains portions of its debt in LIBOR tranches that mature in one to nine months. As those tranches mature, the interest rates on the Company's outstanding borrowings are changed to reflect current prime or LIBOR rates. Therefore, the Company's interest expense changes as the prime or LIBOR rates change. During the second quarter of fiscal 2001, the Company entered into an interest rate swap instrument, designated as a cash flow

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hedge as shown in the following table:

| <u>Rate paid</u> | <u>Rate received</u> | <u>Notional amount</u> | <u>Fair value at 11/02/02</u> |
|------------------|----------------------|------------------------|-------------------------------|
| 5.35% | 3-mo. US Libor | \$ 20,000,000 | \$ (739,000) |

Based on the Company's overall interest rate exposure at November 2, 2002, a hypothetical instantaneous increase or decrease of one percentage point in interest rates applied to borrowings under the credit facility would change the Company's after-tax earnings by approximately \$890,000 over a 12-month period.

The Company's exposure to foreign currency exchange rates is limited because the Company does not operate any stores outside of the United States. The Company does not consider the market risk exposure relating to foreign currency exchange to be material. Foreign currency fluctuations did not have a material impact on the Company during the third quarter of fiscal 2002 or 2001.

The fair value of the Company's investments in marketable equity securities at November 2, 2002 was \$94,000. The fair value of these investments will fluctuate as the quoted market prices of such securities fluctuate. As of November 2, 2002, the fair value of the Company's investments in marketable equity securities was \$108,000 less than the adjusted basis of those investments. Such unrealized holding loss has not been recognized in the Company's consolidated statement of operations, but rather has been recorded as a component of stockholders' equity in other comprehensive loss. The actual gain or loss that the Company will realize when such investments are sold will depend on the fair value of such securities at the time of sale. Based on the Company's marketable equity securities portfolio and quoted market prices at November 2, 2002, a 50% increase or decrease in the market price of such securities would result in an increase or decrease of approximately \$47,000 in the fair value of the marketable equity securities portfolio. Although changes in quoted market prices may affect the fair value of the marketable equities securities portfolio and cause unrealized gains or losses, such gains or losses would not be realized unless the investments are sold or determined to have a decline in value, which is other than temporary.

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ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed of the effectiveness of the design and operation of the Company's disclosure controls and procedures, within 90 days of the filing date of this report. This evaluation was conducted under the supervision and with the participation of the Company's management, including its Chief Executive Officer and its Chief Financial Officer. Based on that evaluation, the Company's Chief Executive Officer and its Chief Financial Officer concluded that the Company's disclosure controls are effective. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls since the date the controls were evaluated.

PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

The information discussed herein includes "forward-looking statements" within the meaning of the federal securities laws. Although the Company believes that the expectations reflected in such forward looking statements are reasonable, the Company's actual results could differ materially as a result of certain factors, including, but not limited to: the Company's ability to manage its expansion efforts in existing and new markets, risks associated with the acquisition of companies, availability of suitable new store locations at acceptable terms, general economic conditions, and retail and sporting goods business conditions, specifically, availability of merchandise to meet fluctuating consumer demands, fluctuating sales margins, increasing competition in sporting goods and apparel retailing, as well as other factors described from time to time in the Company's periodic reports, including the Annual Report of the Company on Form 10-K for its year ended February 2, 2002, filed with the Securities and Exchange Commission.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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The Company is, from time to time, involved in various legal proceedings incidental to the conduct of its business. The Company believes that the outcome of all such pending legal proceedings to which it is a party will not, in the aggregate, have a material adverse effect on the Company's business, financial condition, or operating results.

On July 24, 1997, the IRS proposed adjustments to the Company's and its former parent's (now Thrifty Payless Holdings, Inc., a subsidiary of RiteAid Corporation) 1992 and 1993 federal income tax returns in conjunction with the former parent's Internal Revenue Service examination. The proposed adjustments related to the manner in which LIFO inventories were characterized on such returns. On November 1, 2002, in order to eliminate the accrual of additional interest on taxes owed to the IRS, the Company entered into an agreement with the IRS, based upon the terms of the settlement that is currently pending between the IRS and the Company's former parent. Pursuant to the agreement, the Company paid the IRS taxes of \$1.1 million and interest of \$0.5 million. The Company believes this to be a full and complete settlement of all its separate return issues under review by the IRS, with respect to the Company's inclusion in its former parent's (now Thrifty Payless Holdings, Inc., a subsidiary of RiteAid Corporation) 1992 and 1993 federal income tax returns.

The IRS settlement with the Company's former parent has not been finalized. Under the terms of the Company's tax sharing agreement with its former parent, the Company could be liable for amounts that arise out of the Company's former parent's settlement with the IRS. Based on management's discussions with the Company's former parent and the Company's settlement that was reached with the IRS as described above, the Company believes its portion of the potential accelerated tax liability from the settlement with the IRS by the Company's former parent ranges from approximately \$0 to \$3.3 million. The Company has a long term deferred tax liability of \$3.3 million recorded for the settlement of this matter. The Company does not expect that any penalties will be assessed relating to this matter although the Company cannot be certain that penalties will not be assessed. See note 6 to the consolidated financial statements.

The Company has reviewed the various matters that are under consideration and believes that it has adequately provided for any liability that may result from this matter. In the opinion of management, any additional liability beyond the amounts recorded that may arise as a result of the pending IRS settlement with its former parent will not have a material adverse effect on the Company's consolidated financial condition, results of operations, or liquidity.

In June 2000, a former employee of Sportmart brought two class action complaints in California against the Company, alleging certain wage and hour claims in violation of the California Labor Code, California Business and Professional Code section 17200 and other related matters. One complaint alleges that the Company classified certain managers in its California stores as exempt from overtime pay when they would have been classified as non-exempt and paid overtime. The second complaint alleges that the Company failed to pay hourly employees in its California stores for all hours worked. In March 2001, a third class action complaint was filed in the same court in California alleging the same wage and hour violations regarding classification of certain managers as exempt from overtime pay. In July 2001, a fourth complaint was filed alleging that store managers should also not be classified as employees exempt from overtime pay. All the complaints seek compensatory damages, punitive damages and penalties. The amount of damages sought is unspecified. Although the court denied motions to dismiss the first two complaints, the Company intends to vigorously defend these matters and at this time, the Company has not ascertained the future liability, if any, as a result of these complaints. The Company has not accrued any reserves related to these claims.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

A.
EXHIBITS.

| <u>Exhibit Number</u> | <u>Description</u> |
|-----------------------|--|
| 99.1 | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350). |
| 99.2 | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350). |

B.
REPORTS ON FORM 8-K

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The Company filed no reports on Form 8-K during the quarter ended November 2, 2002.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on November 26, 2002 on its behalf by the undersigned thereunto duly authorized.

GART SPORTS COMPANY

By: /s/ JOHN DOUGLAS MORTON

John Douglas Morton,
Chairman of the Board of Directors, President and Chief
Executive Officer

By: /s/ THOMAS T. HENDRICKSON

Thomas T. Hendrickson,
Executive Vice President, Chief Financial Officer and Treasurer

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CERTIFICATIONS

I, John Douglas Morton, Chairman of the Board of Directors, President and Chief Executive Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Gart Sports Company;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days to the filing date of this quarterly report (the "Evaluation Date"); and

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- c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Effective Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 26, 2002.

/s/ JOHN DOUGLAS MORTON

John Douglas Morton
Chairman of the Board of Directors, President and Chief Executive
Officer
Gart Sports Company

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CERTIFICATIONS

I, Thomas T. Hendrickson, Executive Vice President, Chief Financial Officer and Treasurer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Gart Sports Company;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
 - a)

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designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

- b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days to the filing date of this quarterly report (the "Evaluation Date"); and
- c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Effective Date;

5.

The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6.

The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 26, 2002.

/s/ THOMAS T. HENDRICKSON

Thomas T. Hendrickson
Executive Vice President, Chief Financial Officer and Treasurer
Gart Sports Company

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