

PHOENIX FOOTWEAR GROUP INC

Form 10-K

April 01, 2005

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549**

**FORM 10-K
Annual Report Pursuant to Sec. 13 or 15(d)
of the Securities Exchange Act of 1934**

For the Fiscal Year Ended 1/1/05

Commission File Number 001-31309

Phoenix Footwear Group, Inc.
(Name of Registrant as Specified in its Charter)

Delaware
*(State or Other Jurisdiction of
Incorporation or Organization)*

15-0327010
*(IRS Employer
Identification Number)*

**5759 Fleet Street, Suite 220
Carlsbad, California**
(Address of Principal Executive Offices)

92008
(Zip Code)

**(Registrant's Telephone Number, Including Area Code)
(760) 602-9688**

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

Title of Each Class	Name of Each Exchange On Which Registered
Common Stock, \$.01 Par Value Per Share	American Stock Exchange

**Securities registered pursuant to Section 12(g) of the Act:
None**

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average of the bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second quarter (June 26, 2004) is \$37,613,504.

State the number of shares outstanding of each of the registrant's classes of common equity, as of the latest practical date: CLASS ISSUED & OUTSTANDING AT MARCH 15, 2005, COMMON STOCK, \$.01 PAR VALUE 7,908,490 SHARES

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List hereunder the following documents, if incorporated by reference, and the part of the Form 10-K into which the document is incorporated: Proxy Statement for Annual Meeting of Stockholders to be held in 2005 (incorporated into Part III of Form 10-K).

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Item 1. Business

General

We are a men's and women's footwear and apparel company. We design, develop and market dress and casual footwear and apparel and design, manufacture and market military specification (mil-spec) and commercial combat and uniform boots. Our current brands include Trotters®, SoftWalk®, H.S. Trask®, Strol™, Royal Robbins® and Altama®.

In our footwear and apparel segment, we target the moderate to premium-priced categories of the dress and casual footwear and apparel markets in order to pursue our strategy of maintaining strong operating margins. In this segment we sell over 100 different styles of footwear and over 250 different styles of apparel products. By emphasizing traditional style, quality and fit in this segment, we believe we can better maintain a loyal consumer following that is less susceptible to fluctuations due to changing fashions and changes in consumer preferences. Our design and product development teams seek to create and introduce new products and styles that complement our core products, are consistent with our brand images and meet our high standards.

In our military boot segment, we sell five different product lines under our Altama brand to the military and commercial markets. These product lines include mil-spec combat boots, commercial combat boots, infantry combat boots, tactical boots and safety and work boots. We believe that the majority of products under this brand are not sensitive to fashion risk. We sell our mil-spec boots to the United States Department of Defense, or DoD, and our commercial boots for civilian use through domestic wholesale channels to serve various retailers such as Army/ Navy surplus stores, military catalogs and independent outdoor sporting goods stores and to international wholesalers serving the military and other needs of foreign governments and foreign civilian market.

History and Recent Acquisitions

We have been engaged in the manufacture or importation and sale of quality footwear since 1882. Prior to 1996, we were predominantly a manufacturer and seller of women's slippers. In 1996, James Riedman and Riedman Corporation acquired a 35% ownership position in our common stock, and Mr. Riedman became our Chairman and Chief Executive Officer. Under Mr. Riedman's leadership, we began to streamline our operations and focus on our core competencies of brand specific sales, design and customer service support. We developed a strategy to enhance profitability and growth through recruiting strong management, reducing costs and overhead and acquiring complementary brands.

As part of our transformation, we entered into other areas of the footwear business. In early fiscal 2000, we entered the women's footwear market by acquiring the Penobscot Shoe Company and its Trotters brand of traditional footwear. Later that year we also introduced our new SoftWalk brand of women's comfort footwear. In 2001, in the course of consolidating these new elements of our footwear business, we elected to focus our efforts on the two product lines that were experiencing growth, namely the Trotters and SoftWalk brands, and to sell our men's and women's slipper business.

In August 2003, we entered the men's dress and casual footwear business through our acquisition of the H.S. Trask brand through the purchase of all the outstanding shares of H.S. Trask & Co., a Bozeman, Montana based footwear company. In October 2003, we entered the apparel business with our acquisition of the Royal Robbins apparel brand, through the purchase of all the outstanding shares of Royal Robbins, Inc., a Modesto, California based apparel company.

On June 15, 2004, we hired Richard E. White as our Chief Executive Officer. Prior to joining us, and since 2002, Mr. White was a consultant to trade associations. From 1999 to 2002, he was President and Chief Executive Officer of Reed Exhibitions North America, the largest business-to-business event organizing company in North America. From 1997 to 1999 he was General Manager, Subsidiary Brands, of three of Nike Inc.'s four subsidiary companies, including Cole Haan and Bauer Nike Hockey. Mr. White also was employed for fifteen years by Major League Baseball Properties, Inc. and served as President and Chief Executive Officer for seven of those years.

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In 2004, we entered the military boot market through our acquisition of Altama Delta Corporation. Altama has manufactured military footwear for the DoD, for 36 consecutive years. It also produces a commercial line of high-performance combat boots for civilian use. Since this acquisition we have continued to sell mil-spec combat boots to the DoD market and combat and uniform boots to the commercial market. We have also developed boots for the public safety market and are actively seeking to develop in that market to organizations such as police forces, fire departments, the U.S. Immigration and Naturalization Service, the U.S. Coast Guard and private security services.

With these acquisitions, we added to our portfolio of brands and diversified our product offerings, added significant revenues, diversified and added to our manufacturer and customer base and added manufacturing operations. We intend to continue to pursue acquisitions of footwear and apparel related products companies that we believe have sustainable niche brands that could complement or expand our business, augment our market coverage, provide us with important relationships or otherwise offer us growth opportunities. Although we are actively seeking acquisitions that will expand our existing brands, as of the date of this report we have no agreements to consummate an acquisition and there can be no assurance that we will be able to identify and acquire such businesses or obtain necessary financing on favorable terms.

Our Brands

Through a series of acquisitions, we have built a portfolio of niche brands that we believe exhibit brand growth potential. We intend to continue to build our portfolio of brands through acquisitions of footwear, apparel and related products companies and product lines that complement our existing brands and exhibit these same qualities. Our current brands include Trotters, SoftWalk, Strol, H.S. Trask, Royal Robbins, and Altama.

Business Strategy

Our operations are based on a decentralized, brand focused strategy. Each brand manager is responsible for the product development, marketing, sales growth and profitability of his or her brand. Our approach enables us to address individual production and marketing requirements of our brands and respond to changing market dynamics in a timely manner. At the same time, our corporate infrastructure allows us to achieve economies of scale through shared warehousing, finance functions and information systems in the operations of each of our brands. Our focus is on extending existing brands through our investment in design and product development. We also seek to expand our brand portfolio through creation of additional brands, licensing and acquisitions.

We have developed core strengths that we believe have been significant contributors to our growth to date and will help support future growth. These strengths include:

Portfolio of Current Brands. Through product design, innovation, quality and fit, our consumer brands have built a high degree of consumer and retailer loyalty. We believe our portfolio approach reduces business risk by diversifying the sources of our revenue and cash flow. We believe that our portfolio of brands also provides us with access to a broader array of retailers than could be achieved by any of our brands on a standalone basis. We continue to seek brand acquisition opportunities that complement our existing brands and meet minimum operational, growth and cash flow investment criteria.

Manufacturing Relationships. We believe that one of the key factors in the recent growth of consumer brands has been our strong relationships with overseas manufacturers that are capable of meeting our requirements for quality and price in a timely fashion. We source our dress and casual footwear products primarily from Brazil, our commercial combat and uniform boot products primarily from China and our apparel products primarily from Asia and South America.

Emphasis on Moderate-to-Premium-Priced Categories of the Footwear and Apparel Markets. Our portfolio of brands in the footwear and apparel segment is sold through independent retailers, specialty retailers and better department stores. This distribution strategy distinguishes us from footwear and apparel

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companies that supply the discount or mass merchant channel. We believe our emphasis on providing high-quality premium products allows us to maintain stronger gross profit margins.

Pre-Season Sales Approach. In the footwear and apparel segment we attempt to reduce the inventory risk resulting from changing trends and product acceptance by obtaining orders for at least 50% of our products before each season. We believe that this approach mitigates the risks of carrying obsolete inventory and poor retail sell-through.

Customer Relationships. We support our footwear retailers and combat and uniform boot retailers and, to a lesser extent, our apparel retailers, by maintaining a limited in-stock inventory position for selected styles, which minimizes the time necessary to fill in season customers orders. In addition, we provide our wholesale customers with brand specific sales forces, EDI capability, co-op advertising, point-of-sale displays and assistance in evaluating which products are likely to appeal to their retail customer base.

Seasoned Management Team. We believe our management team, members of which have significant footwear and apparel experience in the areas of design, product development, sourcing and distribution, represents a significant competitive advantage. We also believe that the strength of our management team, our portfolio of brands and our focused business strategy improve our ability to attract and retain key industry personnel.

Growth Strategies

Our growth will depend upon our broadening of the products offered under each brand, expanding distribution of our products and developing or acquiring new brands. Specifically, our growth strategies include:

Growth of Existing Brands. We seek to increase sales of products under each of our existing brands by increasing the assortment of products and through brand extensions, such as our newly introduced H.S. Trask women's product line. We believe that certain areas of our brands are underdeveloped and will benefit from broader product assortment and additional investment in the brands such as further developing the Fall product offerings for Royal Robbins. We also seek to further expand our existing retail opportunities in current channels, such as our recent introduction of the H.S. Trask and Soft Walk brands into the Walking Company independent store chain. We also seek to expand our military boot sales by developing new products in order to compete for new DoD contracts, and to expand commercial boot sales to the broader security market with organizations such as police forces, fire departments, the U.S. Immigration and Naturalization Service, the U.S. Coast Guard and private security services.

Growth with New Brands. We believe that creating or licensing additional brands from third parties will enable us to increase our sales volumes and satisfy the needs of a wider range of customers. We believe we are well-positioned to continue pursuing this strategy due to our historical track record of brand development and ability to obtain working capital financing and the strength of our management team. As an example, the new Strol brand of men's comfort style footwear was developed utilizing the patented footbed technology used in our women's SoftWalk brand.

Growth Through Acquisitions of Footwear, Apparel and Related Products Companies. We continue to seek acquisition opportunities that we believe complement our existing brands. We seek companies or product lines that we believe have brand growth potential. We believe that brand acquisition opportunities currently exist in the footwear, apparel and related products marketplace that would allow us to expand our product offerings and improve our market segment participation. We may also acquire businesses that we feel could provide us with important relationships or otherwise offer us growth opportunities.

Expand Our Internet and Catalog Operations. We currently sell our products through direct consumer catalog solicitation and our own Internet web sites. Although these sales comprise only a small portion of our net sales, we intend to expand these sales to take advantage of their low overhead opportunity for growth. Our catalog and Internet sales also provide opportunities to renew contact with existing consumers of our products, and to acquaint them with our new styles and brands, which enhance our growth.

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Footwear and Apparel. Our current product lines in the footwear and apparel segment consist of women's dress and casual footwear sold under the Trotters, SoftWalk and H.S. Trask brand names, men's dress and casual footwear sold under the Strol and H.S. Trask brand names, outdoor sportswear and travel apparel for both men and women sold under the Royal Robbins brand name. These products emphasize quality, fit and traditional and authentic styles and emphasize the moderate-to-premium-priced categories of the footwear and apparel markets. Many of our products in this segment include our patented footbed technology and others' patented materials, including performance fabrics made with Gore Tex®, Lycra Spandex®, Cordura® nylon and Dri-X-Treme™ wicking finish and Vibram® soles. The following table summarizes our product lines in this segment:

Product Line	Brands	Target Market	Suggested Retail Price
Women's Dress and Casual Footwear	Trotters, SoftWalk, H.S. Trask	Female Consumer Ages 35-60. Medium income, prefers quality and value over price. Comfort and fit are of key importance.	\$ 59-\$139
Men's Dress and Casual Footwear	H.S. Trask, Strol	Male Consumer Ages 40-60. Medium income, professional, wants and demands the highest quality in products purchased.	\$ 99-\$199
Outdoor Sportswear and Travel Apparel	Royal Robbins	Male and Female Consumer Ages 25-55. Outdoor enthusiast, looks for performance features in their casual and outdoor apparel.	\$ 39-\$120

Women's Dress and Casual Footwear. Our women's dress and casual footwear consists of the Trotters and SoftWalk brands and the newly-introduced H.S. Trask women's brand.

The Trotters brand primarily competes in the women's traditional footwear classification at key price points between \$59 and \$99. The broad selection of sizes and widths for our Trotters brand fills an important niche for our female customers. This line emphasizes quality and fit with continuity of style from season to season.

SoftWalk competes in the women's comfort footwear niche. Key price points are between \$89 and \$129. All of our SoftWalk products utilize our patented footbed technology, which provides the consumer with exceptional comfort without compromising style. This product line has exhibited strong growth since its launch in fiscal 2000. We believe SoftWalk's popularity is attributable to its unique combination of comfort and contemporary styling which fills a niche of comfort footwear for our retail customer base.

Our H.S. Trask women's line is a brand extension of our H.S. Trask brand, which historically addressed the men's footwear market, and is positioned in the premium footwear classification. Key price points are between \$99 and \$139. Key classifications include driving moccasins, casual, tailored and slippers.

Men's Dress and Casual Footwear. Our primary men's footwear brand, H.S. Trask, is based on a romantic western image. Our H.S. Trask styles emphasize bison, longhorn and elk leather materials and rugged construction. Our special tanning techniques and the combination of softness and durability found in these leathers enable us to ensure high standards of quality and comfort. Key price points are between \$99 and \$199. We believe this brand has significant growth potential due to its strong brand image. In the future we may seek brand extensions which could result in growth through the introduction of apparel and other accessories, as well as from a broader product assortment in the traditional men's target market.

We are currently in the process of launching our newly developed Strol brand. Strol is intended to be a premium tailored and casual men's line with contemporary styling based upon our patented footbed technology used in our SoftWalk product line. Key price points for the Strol brand are between \$129 and \$199.

Outdoor Sportswear and Travel Apparel. Our Royal Robbins brand product line includes over 250 styles of women's and men's outdoor sportswear and travel apparel emphasizing comfort, rugged style, and specialty fabrics. Key price points are between \$39 and \$120.

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This brand was originally created by Royal Robbins, an internationally acclaimed climber and traveler who, with his wife, founded their outdoor clothing company over 30 years ago to meet the specialty clothing needs of outdoor enthusiasts.

The Royal Robbins brand has strong customer loyalty and is recognized as a core or authentic brand within its retail channel. In fiscal 2003, Royal Robbins was nominated to compete in the Vendor of the Year competition by its largest customer, REI. This honor was bestowed on only 10 out of a total of 800 vendors. We believe that this strong brand heritage provides us with several promising growth opportunities, including:

increasing sales within the men's product offering (currently women's products account for approximately 60% of the brand's offerings);

increasing the sales of the brand's Fall offering which we began to do in fiscal 2004 (currently the Fall season accounts for approximately 41% of the brand's sales);

introducing a line of Royal Robbins footwear; and

broadening our distribution channel for this product line

Military Boot Business. In the military boot segment, we sell both mil-spec boots and commercial combat and uniform boots.

Mil-Spec Combat Boots. The full mil-spec, heavy-gauged leather, vulcanized rubber-soled combat boots are designed to withstand the most severe battlefield conditions. We have a prime contract to manufacture the tan desert boot and black jungle boot for the DoD and are currently under the first option year expiring September 30, 2005 (with another one year option). These boots are used primarily by the U.S. Army and the U.S. Marines. Our mil-spec boots sold to the DoD are priced under the current DoD contract within a range of \$55.00 to \$70.00 per pair, subject to adjustment under the terms of the contract. We are also currently developing new products designed for anticipated solicitations from the DoD. These new products include temperate weather (waterproof) boots, as well as a hot weather boot.

Commercial Combat Boots. Our civilian boots combine the design features of our mil-spec boots with added comfort and durability. The prices for commercial boots generally range from \$45.00 at wholesale to \$120.00 at web retail. Our other commercial product lines are infantry combat boots, tactical boots and safety and work boots. In February 2005, we introduced the new Altama public safety footwear line.

Product Design and Development

We employ separate design and development teams for each of our product lines. Our management believes this approach results in a more responsive design and product development process, which reduces new product introduction lead times. Our sales management and marketing departments also actively participate in the design and product development process by collaborating on opportunities related to new styles, patterns, design improvements and the incorporation of new materials.

We have developed a patented technology utilized in our SoftWalk and Strol brands. We believe this technology enhances our competitive position. The patented technology claims an insole construction for footwear comprising an intermediate member having raised cushioning elements of a height, size and spacing so as to be self-adjusting to the foot. These elements combine to create a shoe with comfort and support that acts like a mattress for the foot.

We manufacture mil-spec boots to meet the rigorous design specifications and quality and administrative requirements included in the DoD contracts. In order to manufacture these boots to military specifications, we lease molds meeting the design specifications of the DoD from Ro-Search, Inc. Altama has licensed this technology from Ro-Search since its inception in 1969. Ro-Search is a wholly-owned subsidiary of Wellco Enterprises, Inc., a direct competitor of our Altama brand and one of the other licensees of the Ro-Search technology. Ro-Search maintains an inventory of molds that meet the DoD requirements for full and half-size DoD boots and licenses them to four mil-spec manufacturers. The current Ro-Search license expires in 2006.

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We anticipate that the DoD will continue to solicit bids for temperate weather (waterproof) infantry combat boots. We plan to compete for these contracts. Altama has entered into a limited license arrangement with W. L. Gore & Associates, Inc., owner of the Gore-Tex technology, to develop waterproof combat boots for DoD procurements.

We have attempted to leverage the Altama mil-spec boot manufacturing experience in the design of our commercial boots by adding comfort and durability to the mil-spec features. In particular, we recently introduced two models of the infantry combat boot by altering the design of the DoD's mil-spec boot. Our commercial combat boots are not guaranteed for battlefield conditions, but look substantially similar to the mil-spec combat boots and are used by military personnel for garrison duty, office and police patrol, guard or parade duty and in other non-combat environments. We offer a tactical model that is made with a leather and fabric upper on a bottom that functions in a manner similar to a running shoe. The tactical boots are targeted towards the public safety market as a police/security duty boot. We also manufacture and design safety and work boots to meet applicable safety requirements targeted broadly towards individuals working in industrial, construction, corrections, warehousing and distribution, packaging and delivery, and private safety workplaces.

We incurred design and product development costs of approximately \$1.2 million in fiscal 2004, \$556,000 in fiscal 2003 and \$315,000 in fiscal 2002. We expect to incur approximately \$1.3 million of design and development costs in fiscal 2005.

Sales and Distribution

Approximately 6,000 stores in the U.S. carry our products, including many major department stores, mail order companies, and specialty footwear and apparel retailers. Our military boot products are sold to the DoD and into the commercial combat and uniform boot market channels. Ten major customers represented approximately 36% of our net sales in fiscal 2004 including the DoD, which comprised 10%. Most of these same customers represented approximately 39% of our net sales in fiscal 2003 and 34% of our net sales in fiscal 2002, not including the DoD. Sales to Dillard's department stores represented 7%, 11% and 12% of our net sales in fiscal 2004, 2003, and 2002, respectively and no other customer exceeded 10% of our net sales during those fiscal years. Dillard sales for 2005 are expected to decline to approximately 3% of total fiscal 2005 sales as a result of a consolidation of Dillard's footwear vendor base, offset by an expected increase in our Dillard's apparel sales. The DoD continues to be the largest and most important customer for our military boot segment and we expect it to be our largest customer in fiscal 2005.

Footwear and Apparel. Our casual and dress footwear products are primarily sold to retailers and catalog companies through our own employee sales force that covers much of the U.S. The Trotters and SoftWalk brands are sold primarily through independent retailers and department stores. Our H.S. Trask line is sold predominantly through independent retailers and catalog sales. We also sell footwear products in Canada and the Caribbean through independent distributors.

Our apparel products are sold in the U.S. primarily through specialty retailers utilizing an independent sales force and two retail stores. We also plan to distribute our apparel products through department stores and have recently begun selling our women's line of Royal Robbins through Dillard's department stores. In Canada, the United Kingdom, Japan and Germany, our apparel products are sold under licensing agreements with third parties. We sell private label products to a small number of customers in amounts that represent an insignificant portion of our total net sales.

Military Boot Business. Government Sales: Whenever the DoD determines a need for combat boots for use by the U.S. armed forces, the Defense Support Center Philadelphia or DSCP, solicits bid responses from U.S. boot manufacturers. Bidding on U.S. government boot solicitations is open to any qualified U.S. manufacturer.

After the contract is awarded, a contractor will receive delivery orders from the DoD, which under normal conditions must be completed in six months. Weekly production lots against the delivery order are presented to the DoD's quality assurance representative, who purchases the boots at our Lexington, Tennessee finishing

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plant. The lot of boots is then the property of the DSCP and is either drop shipped to a specified location or transferred to our Lexington, Tennessee warehouse for storage until the DSCP issues a material release order to pick and ship the boots to a specific DoD installation.

From 1997 through fiscal 2003, Altama operated under several extensions of its contract with the DoD dated April 15, 1997. In early 2002, the DoD issued two solicitations for future boot requirements to replace the original contract that was set to expire on April 15, 2002. One solicitation covered the three current direct molded sole, or DMS, styles of military combat boots, including the standard issue all-leather combat boot that has historically accounted for the majority of the DoD's orders under the contract. On September 30, 2003, the DoD notified Altama that it had been awarded a new contract to produce DMS military combat boots. Four contracts were awarded to U.S. manufacturers and the quantities to be purchased from each manufacturer are 35%, 30%, 20% and 15% of the DSCP total boot purchases. Altama's initial award was for 20% of DSCP total DMS boot purchases. Under the old DMS contract mentioned above, Altama supplied 20% of total DSCP purchases.

The second solicitation covered the newly adopted infantry combat boot, which incorporates a waterproof membrane construction. This boot has replaced the previous DMS all-leather combat boot as the U.S. Army's standard issue combat boot. On March 11, 2003, the DoD advised Altama that it did not win a contract to produce the new waterproof infantry combat boot.

On October 1, 2003, the DSCP contracting officer invoked the surge option for the 2003 contract. As a result, during 2004, Altama operated under a surge option pursuant to which it sold boots to the DoD in excess of the initial maximum amount awarded under its DoD contract. In September 2004, the DoD exercised the first option term under its contract with Altama and at that time increased Altama's portion of the contract volume to 30%. The first year option term runs from October 2004 through September 2005. The maximum pairs that the DoD can order under this option is less than that of the base contract year as a result of the discontinuance of the DMS all leather-combat boot. We have been advised that the DoD does not intend to issue orders in excess of the maximum award during this first option year. Therefore, we will not be operating at surge production rates and our net sales under the Altama brand are expected to be lower in fiscal 2005 than in fiscal 2004.

After starting production under the current DoD contract, the DoD decided to change the specification for the sole of the three styles of DMS military combat boots covered by the contract to a three-layered sole construction. This new construction also includes a mold licensed from RoSearch. Altama invested approximately \$1.0 million in new equipment necessary to construct this new three layered sole.

Our contracts with the DoD are subject to partial or complete termination under certain specified circumstances including, but not limited to, the following circumstances:

the convenience of the government;

the lack of funding; or

our actual or anticipated failure to perform its contractual obligations.

If a contract is partially or completely terminated for its convenience, the DoD is required to negotiate a settlement with us to cover costs already incurred. Altama has never had a contract either partially or completely terminated by the DoD.

Commercial Sales. In fiscal 2004, following our July 19, 2004 Altama acquisition, our sales to the commercial combat and uniform boot market represented approximately 43% of our military boot operation unit volume and 44% of the segment's net sales. Our sales to the commercial market sales are handled by a direct sales organization dedicated to the line. Our military boot operation commercial market sales have been primarily through domestic wholesale channels. We supply domestic retailers and footwear and military catalogs such as U.S. Calvary and Brigade Quartermaster. We have continued to expand international wholesale focusing mostly on providing three mil-spec boots for certain foreign military organizations, and through the agency channel to local, county, state or federal law enforcement agencies.

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Consumer Direct

Footwear and Apparel. We offer direct sales to consumers through our own www.softwalkshoes.com, www.trotters.com, www.hstrask.com and www.royalrobbins.com web sites. We also distribute print catalogs for H.S. Trask, Trotters and SoftWalk. During fiscal 2004 and 2003, catalog sales represented approximately 18% and 30% of net sales of H.S. Trask, respectively. During fiscal 2004, we offered catalog sales for our Trotters and SoftWalk brands, but do not plan on continuing this practice during fiscal 2005.

We believe our catalog and e-commerce web sites offer a significant growth potential while simultaneously complementing our existing wholesale business by increasing consumer awareness of our brands. Sales through our Internet web sites and print catalogs represented approximately 4% of our net sales for both fiscal 2004 and 2003. The products marketed through consumer direct channels are sold at our suggested retail price, enabling us to maintain the full retail margins.

Military Boot Business. We market our combat and uniform boots through established footwear and clothing retailers catalogs and web sites. We have over 500 retailers participating in this program, including large sporting goods retailers such as Dick's Sporting Goods and The Sports Authority and Army/ Navy surplus retailers. We also sell our Altama brand combat and uniform boots over our own www.altama.com web site.

Marketing and Advertising

Footwear and Apparel. We advertise and promote our dress and casual footwear and apparel brands through a variety of methods, including product packaging, print advertising in trade publications, co-op advertising with our retail customers, and direct consumer marketing. Additionally, we attend tradeshows that are generally well-attended by our retail customers and provide a platform for the unveiling of new products and an important source of pre-season sales orders. We avoid granting restricted or exclusive product sale arrangements because we believe that a profitable distribution of our product lines requires the greatest number of outlets.

Military Boot Business. The DoD does not permit advertising literature to be sent to soldiers, other than branded boot boxes. Given Altama's 36 years as a DoD prime contractor, we believe that the Altama brand is widely recognized by U.S. military soldiers and well known for its product quality and functionality. Our marketing strategy for the military boot commercial channel consists of direct advertising through military publications and direct mail to retailers and agencies. We also seek to build brand recognition and customer loyalty through a practice of including logo t-shirts and posters inside its boot boxes for its website generated sales. We have posted advertisements in the Army Times, Navy Times, Marine Times and Air Force Times, and utilize our web site to market products to the commercial market, including U.S. military soldiers, agency members, members of foreign militaries and general retail customers in the U.S.

Manufacturing and Sourcing

Footwear and Apparel. We source our products in our footwear and apparel segment entirely through independent foreign third-party manufacturing facilities. We provide the independent manufacturers with detailed specifications and quality control standards. We currently source our footwear products for this segment primarily from Brazil and, to a lesser extent, China, and source our apparel products through Asia and South America. We utilize an agency relationship in Brazil to monitor the production process to ensure high quality standards and timely delivery. We also engage foreign agencies to assist in product fulfillment, quality control and inspection, customs and product delivery logistics. We do not maintain long-term purchase commitments with our manufacturers, but rather use individual purchase orders. We use multiple sources for our foreign sourced products in an effort to reduce the risk of reliance on any one manufacturing facility or company. We believe that the various raw materials and components used in the manufacture of our products are generally available from multiple sources at competitive prices. See Factors That May Affect Forward-Looking Statements Our reliance on independent manufacturers for almost all of our non mil-spec products, with whom we do not have long-term written agreements, could cause delay and damage customer relationships.

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Military Boot Business. DoD guidelines require that all mil-spec boots for combat use be manufactured in the U.S. with U.S. materials. As a result, we manufacture all DoD military footwear that we sell. In addition, we manufacture some of our commercial boots. We maintain two manufacturing plants to meet these needs. We have a 23,000 square foot cut and stitch manufacturing plant which is located in Salinas, Puerto Rico. As of March 1, 2005, approximately 115 employees worked at this facility.

We ship partially completed boots to our Lexington, Tennessee facility where the boots are then lasted, bottomed and finished. As of March 1, 2005, we employed 92 people at the Lexington facility, the majority of whom are compensated by the number of pairs they produce. All finished products are then packed for shipping to either our 30,000 square foot warehouse facility located five miles from the Lexington facility, or in the case of commercial product, to a third party warehouse in Chicago, Illinois.

Leather, Cordura® nylon and rubber are the principal material components used in the boot manufacturing process. Pursuant to DoD contracts for military combat boots, all materials used in manufacturing these boots must be and are produced in the U.S. and must conform to military specifications. A majority of our raw materials for our combat and uniform boots can be obtained from various sources and are readily available. Because all materials in boots sold to the DoD must meet rigid DoD specifications and because quality is the first priority, we purchase most of our raw materials for these boots from vendors who provide the best materials at a reasonable cost.

We source a substantial majority of our commercial combat and uniform boots from two China-based manufacturers. Commercial product is shipped to a third party that manages all logistics and distribution of this commercial inventory.

Seasonality and Weather

Footwear and Apparel. Our product lines in the footwear and apparel segment are sold during two distinct selling seasons, Spring/Summer and Fall/Winter. We attempt to design and develop our new product introductions for this segment to coincide with this seasonal trend. Trotters and SoftWalk sales are approximately evenly split between these two seasons, while Royal Robbins products are purchased and used predominantly during the Spring and Summer months. Conversely, our H.S. Trask men's dress and casual footwear lines are purchased and used by consumers predominantly in the Fall and Winter months.

Military Boot Business. Many factors affect the government's demand for boots, so the quantity purchased can vary from year to year. Contractors cannot influence the government's boot needs. Price, quality, quick delivery and manufacturing efficiency are the areas emphasized by our military boot segment to strengthen its competitive position. While the government's demand for boots varies from month to month, business in our Altama brand is not seasonal.

Backlog

For sales made in our footwear and apparel segment, we typically enter a selling season four to six months in advance of the orders being shipped. For our footwear business, approximately 50% of our sales are based on orders placed in advance of the selling season and the remaining sales are on an at once basis during the selling season. For our apparel products, our preorder business represents approximately 80% to 85% of our total sales, with the remaining sales being made on an at once basis during the selling season. We have backlog orders for our Spring business in December of the preceding year and for our Fall business in June of the same year. As of March 1, 2005 our footwear and apparel segment had cancellable backlog orders of approximately \$18.3 million, compared with approximately \$9.6 million as of March 1, 2004. We anticipate the majority of our backlog orders as of March 1, 2005 will be filled during fiscal 2005.

In the military segment, our backlog of firm orders for combat and uniform boots at March 1, 2005 totaled approximately \$265,000, as compared to \$12.9 million as of that time in fiscal 2004, when we did not own Altama. We expect to fill all of the backlog orders during fiscal 2005.

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Employees

We believe we enjoy a good relationship with our employees. As of March 1, 2005, we employed approximately 344 individuals most of whom are full-time. The majority of our employees are employed in our Puerto Rico and Tennessee manufacturing facilities. As of March 1, 2005, we employed approximately 35 individuals as our executive and administrative office employees at our Carlsbad, California corporate headquarters. No employee is represented by a labor union, and we have never suffered an interruption of business caused by labor disputes.

Trademarks and Patents

We regard our proprietary rights as valuable assets and as important to our competitive advantage. Our trademarks include Trotters, SoftWalk, H.S. Trask, Royal Robbins and Altama which we have registered in the U.S. and many foreign countries. We also have rights to use the Audubon trademark. In addition, we have applied for trademark registration of the Strol logo in the U.S., Canada and Israel.

Our SoftWalk and Strol brands contain a patented technology in the footbed of the shoe, for which we own a patent in the U.S. We vigorously protect our intellectual property against infringement. In June 2004, we filed a lawsuit against Mark Tucker, Inc., Sears, Roebuck and Co., Saks Incorporated, Saks & Company, and Saks Fifth Avenue Enterprises, Inc. for infringement of our United States patent No. 6,675,501 relating to the insole construction for our SoftWalk and Strol brand footwear. See Item 3 Legal Proceedings for a further discussion.

We cannot be sure, however, that our activities do not, and will not, infringe on the proprietary rights of others. See Factors That May Affect Forward Looking Statements Our ability to compete could be jeopardized if we are unable to protect our intellectual property rights or if we are sued for intellectual property infringement.

Competition

Footwear and Apparel. We face intense competition in the footwear and apparel industry from numerous domestic and foreign footwear and apparel designers and marketers.

Our Trotters footwear line primarily competes with the Naturalizer®, EasySpirit®, Munro America® and Ros Hommerson® brands, as well as with retailers private label footwear. Our SoftWalk footwear line primarily competes with the EasySpirit® and ECCO® brands. Our H.S. Trask footwear line primarily competes with the Cole-Haan®, ECCO® and Mephisto® brands. Our Royal Robbins apparel lines compete primarily with Patagonia®, The North Face® and Columbia Sportswear Company®.

Many of our competitors have greater financial, distribution or marketing resources than we do, as well as greater brand recognition. Our ability to compete successfully depends on our ability to:

anticipate and respond to changing consumer demands in a timely manner;

maintain brand reputation and authenticity;

develop high quality products that appeal to consumers;

appropriately price our products;

provide strong and effective marketing support for our products;

ensure product availability; and

maintain and effectively access our distribution channels.

We believe we are well positioned to compete in the footwear and apparel industry. By emphasizing traditional style, quality and fit, we believe we can maintain a loyal consumer following that is less susceptible to fluctuations due to changing fashions and changes in consumer preferences.

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Military Boot Business. No one company dominates the DoD boot market. The major competitors within the mil-spec boot category include our Altama brand, Belleville Shoe Manufacturing Company, McRae Industries, Wellco Enterprises and Wolverine® World Wide s Bates® Uniform Footwear division. Price, quality, manufacturing efficiency and delivery are the main competitive forces in the industry. The production allocation of the September 30, 2003 DoD contract was initially as follows: McRae Industries (35%), Wellco Enterprises (30%), Altama (20%) and Belleville Shoe Manufacturing (15%). Our percentage of the award increased to 30% during the first option year, which runs from October 1, 2004 through September 30, 2005. With respect to the infantry combat boot contract three other manufacturers received the award Wellco Enterprises, Belleville Shoe Manufacturing and Wolverine® World Wide s Bates® Uniform Footwear division. This additional competition could make it more difficult for Altama to win a contract with respect to future bid solicitations.

In the commercial market for boots, we compete with a large and diverse set of footwear companies. The commercial market is divided into various categories, with several footwear companies supplying one or more of the following types of boot: military, safety and work, outdoor, casual, fashion, western and motorcycle. These footwear companies distribute their products through several channels, including specialty footwear retailers, specialty outdoor retailers, department stores, sporting goods stores, shoe retailer chains and various other retailers.

Regulation

We are subject to various laws and regulations concerning our contracting with the DoD and environmental and employee safety and health matters related to our manufacturing operations for our Altama brand. We believe that we are operating in substantial compliance with these laws and regulations.

Factors That May Affect Forward Looking Statements***Our acquisitions or acquisition efforts, which are important to our growth, may not be successful, which may limit our growth or adversely affect our results of operations and financial condition***

Acquisitions have been an important part of our development to date. During fiscal 2003, we acquired Royal Robbins and H.S. Trask and during fiscal 2004, we acquired Altama. As part of our business strategy, we intend to make additional acquisitions of footwear, apparel and related products companies that could complement or expand our business, augment our market coverage, provide us with important relationships or otherwise offer us growth opportunities. If we identify an appropriate acquisition candidate, we may not be able to negotiate successfully the terms of or finance the acquisition. In addition, we cannot assure you that we will be able to integrate the operations of our acquisitions without encountering difficulties, including unanticipated costs, possible difficulty in retaining customers and supplier or manufacturing relationships, failure to retain key employees, the diversion of management attention or failure to integrate our information and accounting systems. Following an acquisition, we may not realize the revenues and cost savings that we expect to achieve or that would justify the acquisition investment, and we may incur costs in excess of what we anticipate. These circumstances could adversely affect our results of operations or financial condition.

Our future success depends on our ability to respond to changing consumer preferences and fashion trends and to develop and commercialize new products successfully

A significant portion of our principal business is the design, development and marketing of dress and casual footwear and apparel. Although our focus in this segment of our business is on traditional and sustainable niche brands, our consumer brands may still be subject to rapidly changing consumer preferences and fashion trends. For example, in fiscal 2004, our Trotters brand experienced decreased retail acceptance of certain styles, which adversely affected our net sales. Accordingly, we must identify and interpret fashion trends and respond in a timely manner. Demand for and market acceptance of new products, such as our H.S. Trask women s and Strol brands and our new Altama public safety footwear line, are uncertain, and achieving market acceptance for new products generally requires substantial product development and marketing efforts and expenditures. Any failure on our part to regularly develop innovative products and update core products

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could limit our ability to differentiate and appropriately price our products, adversely affect retail and consumer acceptance of our products, and limit sales growth. Each of these risks could adversely affect our results of operations or financial condition.

We face intense competition, including competition from companies with greater resources than ours, and if we are unable to compete effectively with these companies, our market share may decline and our business and stock price could be harmed

We face intense competition in the footwear and apparel industry from other companies, such as Brown Shoe Company, which markets the Naturalizer® brand, and Columbia Sportswear Company®. We also face competition from several companies in our military boot operations. Many of our competitors have greater financial, distribution or marketing resources, as well as greater brand awareness. In addition, the overall availability of overseas manufacturing opportunities and capacity allow for the introduction of competitors with new products. Moreover, new companies may enter the markets in which we compete, further increasing competition in the footwear and apparel industry.

We believe that our ability to compete successfully depends on a number of factors, including anticipating and responding to changing consumer demands in a timely manner, maintaining brand reputation and authenticity, developing high quality products that appeal to consumers, appropriately pricing our products, providing strong and effective marketing support, ensuring product availability and maintaining and effectively assessing our distribution channels, as well as many other factors beyond our control. Due to these factors within and beyond our control, we may not be able to compete successfully in the future. Increased competition may result in price reductions, reduced profit margins, loss of market share, and an inability to generate cash flows that are sufficient to maintain or expand our development and marketing of new products, each of which would adversely affect the trading price of our common stock.

A large portion of our sales are to a relatively small group of customers with whom we do not have long-term purchase orders, therefore the loss of any one or more of these customers could adversely affect our business

Ten major customers represented approximately 36% of net sales in fiscal 2004, including the DoD, which comprised 10%. Most of these same customers, except the DoD, represented 39% of net sales in fiscal 2003 and 34% of net sales in fiscal 2002. Sales to Dillard's department stores represented 7%, 11% and 12% of our net sales in fiscal 2004, 2003, and 2002, respectively and no other customer exceeded 10% of our net sales during those fiscal years. Dillard sales for 2005 are expected to decline to approximately 3% of total fiscal 2005 sales as a result of a consolidation of Dillard's footwear vendor base offset by an expected increase in our Dillard's apparel sales. Although we have long-term relationships with many of our customers, our customers do not have a contractual obligation to purchase our products, and we cannot be certain that we will be able to retain our existing major customers. The retail industry can be uncertain due to changing customer buying patterns and consumer preferences, and customer financial instability. These factors could cause us to lose one or more of these customers, which could adversely affect our business. We expect the DoD to be our largest customer in fiscal 2005. Material reductions in the level of orders from the DoD would harm our operating results and deprive us of the benefits that we expect to receive from the Altama acquisition.

The financial instability of our customers could adversely affect our business and result in reduced sales, profits and cash flows

We sell much of our merchandise in our footwear and apparel segment to major department stores and specialty retailers across the U.S. and extend credit based on an evaluation of each customer's financial condition, usually without requiring collateral. However, the financial difficulties of a customer could cause us to curtail business with that customer. We may also assume more credit risk relating to that customer's receivables due us. Two of our customers constituted 16% of trade accounts receivable outstanding at January 1, 2005. Our inability to collect on our trade accounts receivable from any of our major customers could adversely affect our business or financial condition.

Table of Contents***Our ability to compete could be jeopardized if we are unable to protect our intellectual property rights or if we are sued for intellectual property infringement***

We believe that we derive a competitive advantage from our ownership of the Trotters, SoftWalk, H.S. Trask, Royal Robbins and Altama trademarks, and our patented footbed technology. In addition, we own and license other trademarks that we utilize in marketing our products. We vigorously protect our trademarks against infringement. We believe that our trademarks are generally sufficient to permit us to carry on our business as presently conducted. We cannot, however, know whether we will be able to secure trademark protection for our intellectual property in the future or that protection will be adequate for future products. Further, we face the risk of ineffective protection of intellectual property rights in the countries where we source our products. We cannot be sure that our activities do not and will not infringe on the proprietary rights of others. If we are compelled to prosecute infringing parties, defend our intellectual property, or defend ourselves from intellectual property claims made by others, we may face significant expenses and liability that could divert our management's attention and resources and otherwise adversely affect our business or financial condition.

Our international manufacturing operations are subject to the risks of doing business abroad, which could affect our ability to manufacture our products in international markets, obtain products from foreign suppliers or control the costs of our products

We currently rely on foreign sourcing of our products, other than most of our military footwear. We believe that one of the key factors in our growth has been our strong relationships with manufacturers capable of meeting our requirements for quality and price in a timely fashion. We obtain our foreign-sourced products primarily from independent third-party manufacturing facilities located in Brazil and Asia. As a result, we are subject to the general risks of doing business outside the U.S., including, without limitation, work stoppages, transportation delays and interruptions, political instability, expropriation, nationalization, foreign currency fluctuation, changing economic conditions, the imposition of tariffs, import and export controls and other non-tariff barriers, and changes in local government administration and governmental policies, and to factors such as the short-term and long-term effects of severe acute respiratory syndrome, or SARS, and the outbreak of avian influenza in China. Although a diverse domestic and international industry exists for the kinds of merchandise sourced by us, there can be no assurance that these factors will not adversely affect our business, financial condition or results of operations.

Our reliance on independent manufacturers for almost all of our non mil-spec products, with whom we do not have long-term written agreements, could cause delay and damage customer relationships

In fiscal 2004, 11 manufacturers accounted for 100% of our dress and casual footwear and 5 manufactures accounted for 58% of our apparel volume. Two foreign manufactures accounted for 100% of our non mil-spec boot volume. Taking into account the inclusion of Altama, for a full fiscal year following the 2004 acquisition we anticipate in fiscal 2005 that approximately 81% of our net sales could come from products sourced from third party manufacturers. We do not have long-term written agreements with any of our third-party manufacturers. As a result, any of these manufacturers may unilaterally terminate their relationships with us at any time. Establishing relationships with new manufacturers would require a significant amount of time and would cause us to incur delays and additional expenses, which would also adversely affect our business and results of operations.

In addition, in the past, a manufacturer's failure to ship products to us in a timely manner or to meet the required quality standards has caused us to miss the delivery date requirements of our customers for those items. This, in turn, has caused, and may in the future cause, customers to cancel orders, refuse to accept deliveries or demand reduced prices. This could adversely affect our business and results of operation.

Our results could be adversely affected by disruptions in the manufacturing system for our Altama brand

Since July 2004, Altama's manufacturing operations produced approximately 80% of the products sold under the Altama brand. We expect that these products could represent over 19% of our combined net sales in

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fiscal 2005. In September 2004 we encountered production delays at our Puerto Rico manufacturing plant after a closure for several days due to severe weather. Any significant disruption in those operations for any reason, such as power interruptions, fires, hurricanes, war or other force majeure, could adversely affect our sales and customer relationships and therefore adversely affect our business.

If we are unable to replace revenues from sales to the DoD of products planned to be discontinued, our net sales and our consolidated operating results would be adversely affected

Under our current contract with the DoD under our Altama brand, we manufactured three models of mil-spec combat boots during the first year of the contract which ended September 30, 2004. One of these models, the all-leather combat boot, was discontinued by the DoD, in favor of a new waterproof infantry combat boot, and is not subject to the first year option under the DoD contract under which we are currently operating. Pro forma net sales under the Altama brand of the all-leather combat boot to the DoD during fiscal 2004 were \$2.5 million, representing approximately 9% of Altama's pro forma net sales from sales to the DoD for fiscal 2004.

In March 2003, the DSCP awarded contracts to supply the infantry combat boot. To date, we have not been awarded a contract to produce the new infantry combat boot. While there may be additional opportunities to bid on the infantry combat boot and other waterproof boot contracts in the future, particularly as the U.S. Army transitions from the all-leather combat boot, our failure to be awarded a contract in March 2003 may be a significant disadvantage in bidding on future contracts. Consequently, we anticipate that our net sales to the DoD will decline if we are not able to obtain awards of contracts for infantry combat boots or any other new models or increased percentages of awards for existing mil-spec boots we currently manufacture.

Doing business with the U.S. government entails many risks that could adversely affect us through the early termination of our contracts or by interfering with Altama's ability to obtain future government contracts

Our contracts with the DoD under the Altama brand are subject to partial or complete termination under specified circumstances including, but not limited to, the following circumstances:

the convenience of the government;

the lack of funding; or

our actual or anticipated failure to perform our contractual obligations.

Additionally, there could be changes in government policies or spending priorities as a result of election results or changes in political conditions or other factors that could significantly affect the level of troop deployment. Any of these occurrences could adversely affect the level of business we do with the DoD and, consequently, our operating results. For example, the DoD has advised us that it will not order in excess of the maximum volume under the first year option of its current DoD contract and, therefore, the volume of orders does not require us to operate at surge rates as was the case during fiscal 2004.

There is no certainty that the DSCP will exercise renewal options on any contract we may have or that we will be awarded future DSCP boot solicitations. Most boot contracts are for multi-year periods. Therefore, a bidder not receiving an award from a significant solicitation could be adversely affected for several years.

The DSCP and other DoD agencies with which Altama may do business are also subject to unique political and budgetary constraints and have special contracting requirements and complex procurement laws that may affect the contract or Altama's ability to obtain new government customers. These agencies often do not set their own budgets and therefore have little control over the amount of money they can spend. In addition, these agencies experience political pressure that may dictate the manner in which they spend money. Due to political and budgetary processes and other scheduling delays that frequently occur in the contract or bidding process, some government agency orders may be canceled or substantially delayed, and the receipt of revenues or payments may be substantially delayed.

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Government agencies have the power, based on financial difficulties or investigations of their contractors, to deem contractors unsuitable for new contract awards. Because we engage in the governmental contracting business, we will be subject to audits and may be subject to investigation by governmental entities. Failure to comply with the terms of any of these government contracts could result in substantial civil and criminal fines and penalties, as well as our suspension from future government contracts for a significant period of time, any of which could adversely affect our business by requiring us to spend money to pay the fines and penalties and prohibiting us from earning revenues from government contracts during the suspension period.

Furthermore, our failure to qualify as a small business under federal regulations following the acquisition could reduce the likelihood of our ability to receive awards of future DoD contracts. Altama qualified as a small business at the time of its bid for the current DoD contract. Small business status, having less than 500 employees, is a factor that the DoD considers in awarding its military boot contracts. Our combined employment with Altama could exceed 500 employees in the future, which could adversely affect our ability to obtain future contract awards

The sales of the Altama brand to the commercial market have grown at significant rates over the past three years, and there can be no assurance that our net sales growth under this brand will continue at this rate

In the last three fiscal years, Altama's net sales from sales to the commercial market have grown significantly. This has contributed in part to Altama's overall growth in net sales over that period. This growth has been due in part to added customer demand, increased pricing and expansion of customers, and in particular, higher international demand as the result of increasing military and security personnel to fight the war on terrorism. There is no assurance that this level of demand will continue or that we will be able to achieve or maintain this level of growth in the commercial market after the acquisition.

We depend on our senior executives to develop and execute our strategic plan and manage our operations, and if we are unable to retain them, our business could be harmed

Our future success depends upon the continued services of James Riedman, our Chairman of the Board, who has played a key role in developing and implementing our strategic plan. We also rely on Richard E. White, our Chief Executive Officer and Kenneth E. Wolf, our Chief Financial Officer, who have played key roles in integrating our newly acquired brands. Our loss of any of these individuals would harm us if we are unable to employ a suitable replacement in a timely manner. We do not maintain key man insurance on Messrs. Riedman, White or Wolf or any of our other senior executives.

Fluctuations in the price, availability and quality of raw materials could adversely affect our gross profit

Fluctuations in the price, availability and quality of raw materials, such as leather and bison hides, used to manufacture our products, could adversely affect our cost of goods or our ability to meet our customers' demands. Although we do not expect our foreign manufacturing partners, or ourselves in manufacturing our Altama brand, to have any difficulty in obtaining the raw materials required for footwear production, certain sources may experience some difficulty in obtaining raw materials. For example, in fiscal 2002, the availability of leather decreased as a result of destruction of livestock due to concerns about mad cow disease and hoof and mouth disease. We generally do not enter into long-term purchase commitments. In the event of price increases in these raw materials in the future, we may not be able to pass all or a portion of these higher raw materials prices on to our customers, which would adversely affect our gross profit.

A decline in general economic conditions could lead to reduced consumer demand for our products and could lead to a reduction in our net sales, and thus in our ability to obtain credit

In addition to consumer fashion preferences, consumer spending habits are affected by, among other things, prevailing economic conditions, levels of employment, salaries and wage rates, consumer confidence and consumer perception of economic conditions. For example, in fiscal 2003 the U.S. economy, and more specifically the retail environment, experienced a general slowdown, and adversely affected consumer spending

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habits. Future slowdowns would likely cause us to delay or slow our expansion plans and result in lower net sales than expected on a quarterly or annual basis, which could lead to a reduction in our stockholders' equity and thus our ability to obtain credit as and when needed.

Our recently completed acquisitions make evaluating our operating results difficult given the significance of these acquisitions to our operations, and our historical results do not give you an accurate indication of how we will perform in the future

Our historical results of operations do not give effect for a full fiscal year to our 2004 acquisition of Altama. Accordingly, our historical financial information does not necessarily reflect what our financial position, operating results and cash flows will be in the future as a result of this acquisition, or give you an accurate indication of how Phoenix Footwear, including the Altama operations, will perform in the future.

Additionally, our management team has limited experience in selling to the government, which comprises a significant amount of net sales under the Altama brand.

The financing of any future acquisitions we make may result in dilution to your stock ownership and/or could increase our leverage and our risk of defaulting on our bank debt

Our business strategy is to expand into new markets and enhance our position in existing markets through acquisitions. In order to successfully complete targeted acquisitions or to fund our other activities, we may issue additional equity securities that could dilute your stock ownership. We may also incur additional debt if we acquire another company, which could significantly increase our leverage and hence our risk of default under our secured credit facility. For example, in financing our recent Altama acquisition we issued 2,500,000 shares of our common stock in a registered public offering, issued 196,967 shares of our common stock in a private placement to Altama's sole shareholder and incurred approximately \$10.0 million of additional debt under our amended credit facility to pay the purchase price and to refinance Altama's funded indebtedness.

Defaults under our secured credit arrangement could result in a foreclosure on our assets by our bank

We have a \$37.4 million secured credit facility with our bank. As of February 26, 2005, we had \$32.0 million outstanding under this facility. In the future, we may incur additional indebtedness in connection with other acquisitions or for other purposes. All of our assets are pledged as collateral to secure our bank debt. Our credit facility includes a number of covenants, including financial covenants. If we default under our credit arrangement and are unable to cure the default, obtain appropriate waivers or refinance the defaulted debt, our bank could declare our debt to be immediately due and payable and foreclose on our assets, which may result in a complete loss of your investment.

We may be required to recognize impairment charges that could adversely affect our reported earnings in future periods

Our business acquisitions typically result in goodwill and other intangible assets. As of January 1, 2005, we had \$38.3 million of goodwill and unamortizable intangibles. We expect this figure to continue to increase with additional acquisitions. Pursuant to generally accepted accounting principles in the United States, we are required to perform impairment tests on our goodwill annually or at any time when events occur that could impact the value of our business. Our determination of whether an impairment has occurred is based on a comparison of each of our reporting units' fair market value with its carrying value. Significant and unanticipated changes could require a provision for impairment in a future period that could adversely affect our reported earnings in a period of such change.

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The exercise of outstanding stock options and warrants, and the allocation of unallocated shares held by our 401(k) plan, would cause dilution to our stockholders ownership percentage and/or a reduction in earnings per diluted share

As of March 15, 2005, we had outstanding 7,908,490 shares of common stock, including 358,885 unallocated shares held by our 401(k) plan, which despite the fact they are outstanding for voting and other legal purposes, are classified as treasury shares for financial statement reporting purposes and are not taken into account in determining our earnings per share or earnings per diluted share. The 358,885 unallocated shares will be allocated at the rate of approximately 120,000 shares annually until they are fully allocated to the accounts of plan participants. After each allocation these additional shares will be included in the weighted average shares outstanding for purposes of determining our earnings per share and earnings per diluted share. In addition, as of that date, we had outstanding options and warrants to purchase 1,435,356 shares at exercise prices ranging from \$1.73 to \$15.00 per share. The exercise of all or part of these options or warrants would cause our stockholders to experience a dilution in their percentage ownership for legal purposes.

The charge to earnings from the compensation to employees under our employee retirement plan could adversely affect the value of your investment in our common stock

As of March 15, 2005, our 401(k) plan held 358,885 unallocated shares of our common stock, which constituted approximately 4% of our outstanding shares as of that date. Under the terms of the plan, approximately 120,000 of these shares will be allocated to plan participants in February of each year until fully allocated of which approximately 120,000 were allocated in February 2005. We are required to record an expense for compensation based on the market value of the amount allocated to employees each year. For fiscal 2003 and 2004, we recorded non-cash expenses for this allocation of \$402,000 and \$854,000, respectively. To the extent our stock price increases, we would be required to take a higher charge for this allocation and thereby decrease our reported earnings. This could adversely affect the value of your investment in our common stock.

We are controlled by a principal stockholder who may exert significant control over us and our significant corporate decisions in a manner adverse to your personal investment objectives, which could depress the market value of our stock

James R. Riedman, our Chairman of the Board, is the largest beneficial owner of our stock. Through his personal holdings and shares over which he is deemed to have beneficial ownership held by Riedman Corporation (of which he is a shareholder, President and a director), our employee retirement plan, his children, and an affiliated entity, he beneficially owned approximately 28.4% of our outstanding shares as of March 15, 2005. Mr. Riedman also has beneficial ownership of shares underlying options which, if exercised, would increase his percentage beneficial ownership to approximately 33.7% as of March 15, 2005. Through this beneficial ownership, Mr. Riedman can direct our affairs and significantly influence the election or removal of our directors and the outcome of all matters submitted to a vote of our stockholders, including amendments to our certificate of incorporation and bylaws and approval of mergers or sales of substantially all of our assets. The interest of our principal stockholder may conflict with interests of other stockholders. This concentration of ownership may also harm the market price of our common stock by, among other things:

delaying, deferring or preventing a change in control of our company;

impeding a merger, consolidation, takeover or other business combination involving our company;

causing us to enter into transactions or agreements that are not in the best interests of all stockholders; or

discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of our company.

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Our inventory levels may exceed our actual needs, which could adversely affect our operating results by requiring us to make inventory write-downs

If we order more product than we are able to sell, we could be required to write-down this inventory, adversely affecting our margins and in turn, our operating results. Additional, excess inventory adversely affects our liquidity. Excess inventory could occur as the result of change in customer order patterns, general sales activity, orders subject to cancellation by customers, misforecasting and consumer demand. Write-downs of inventory could adversely affect our gross profit and operating results.

Our financial results may fluctuate from quarter to quarter as a result of seasonality in our business, and if we fail to meet expectations, the price of our common stock may fluctuate

The footwear and apparel industry generally, and our business specifically, are characterized by seasonality in net sales and results of operations. Our business is seasonal, with the first and third quarters generally having stronger sales and operating results than the other two quarters. These events could cause the price of our common stock to fluctuate.

Delaware law, our charter documents and agreements with our executives may impede or discourage a takeover, even if a takeover would be in the interest of our stockholders

We are a Delaware corporation, and the anti-takeover provisions of Delaware law impose various impediments to the ability of a third-party to acquire control of us, even if a change in control would be beneficial to our existing stockholders. In addition, our Board of Directors has the power, without stockholders' approval, to designate the terms of one or more series of preferred stock and issue shares of preferred stock, which could be used defensively if a takeover is threatened. All options issued under our stock option plans automatically vest upon a change in control unless otherwise determined by the compensation committee. In addition, several of our executive officers have employment agreements that provide for significant payments on a change in control. These factors and provisions in our certificate of incorporation and bylaws could impede a merger, takeover or other business combination involving us or discourage a potential acquirer from making a tender offer for our common stock or reduce our ability to achieve a premium in such sale, which could limit the market value of our common stock and prevent you from maximizing the return on your investment.

Shares of our common stock eligible for public sale could cause the market price of our stock to drop, even if our business is doing well

Sales of a substantial number of shares of our common stock in the public market, or the perception that these sales could occur, could adversely affect the market price for our common stock. As of March 15, 2005, there were 7,908,490 shares of our common stock outstanding. Of our currently outstanding shares of common stock, 4,734,611 shares are freely tradable without restriction or further registration under federal securities laws, including 40,563 shares held by our affiliates which are registered for resale on a Form S-8. The remaining 3,173,879 shares are held by our affiliates or were issued in a private placement and are considered restricted or control securities and are subject to the trading restrictions of Rule 144 under the Securities Act of 1933, as amended, or the Securities Act. These securities cannot be sold unless they are registered under the Securities Act or unless an exemption from registration is otherwise available. We also have in effect registration statements on Form S-8 covering 1,500,000 shares of common stock, under our 2001 Long-Term Incentive Plan, 1,092,557 shares of which are subject to previously granted options and the remainder of which are available for future awards under that plan.

Our principal stockholders, James Riedman and Riedman Corporation, who beneficially own in the aggregate 2,252,461 shares of our common stock and vested options to acquire an additional 560,084 shares, have demand registration rights covering 1,152,710 of the shares they beneficially own. In connection with our recent Altama acquisition, we entered into a registration rights agreement with Altama's sole shareholder for 196,967 shares issued in a private placement to him in connection with the acquisition.

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The registration rights agreement grant to Altama's sole shareholder, subject to certain conditions, one demand registration exercisable between 180 days and three years after the acquisition closing and unlimited piggyback registration rights for registration statements we file with the SEC during the three years following the closing except in limited circumstances.

Significant resales of these shares could cause the market price of our common stock to decline regardless of the performance of our business. These sales also might make it difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate.

Our stock price has fluctuated significantly during the past 12 months and may continue to do so in the future, which could result in litigation against us and significant losses for investors

Our stock price has fluctuated significantly during the past 12 months and in the future may continue to do so. A number of factors could cause our stock price to continue to fluctuate, including the following:

the failure of our quarterly operating results or those of similarly situated companies to meet expectations;

adverse developments in the footwear or apparel markets and the worldwide economy;

changes in interest rates;

our failure to meet investors' expectations;

changes in accounting principles;

sales of common stock by existing stockholders or holders of options;

announcements of key developments by our competitors;

the reaction of markets to announcements and developments involving our company, including future acquisitions and related financing activities; and

natural disasters, riots, wars, geopolitical events or other developments affecting us or our competitors.

In addition, in recent years the stock market has experienced extreme price and volume fluctuations. This volatility has had a significant effect on the market prices of securities issued by many companies for reasons unrelated to their operating performance.

These broad market fluctuations may adversely affect our stock price, regardless of our operating results. In the past, securities class action litigation often has been brought against a company following periods of volatility in the market price of its securities. We may in the future be the target of similar litigation. Securities litigation could result in substantial costs and liabilities and could divert management's attention and resources.

CAUTIONARY STATEMENT

CONCERNING FORWARD-LOOKING INFORMATION

This Annual Report on Form 10-K and the Securities and Exchange Commission filings that are incorporated by reference into this Annual Report on Form 10-K contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. We intend that these forward-looking statements be subject to the safe harbors created by those sections.

These forward-looking statements include, but are not limited to, statements relating to our anticipated financial performance, business prospects, new developments, new merchandising strategies and similar matters, and/or statements preceded by, followed by or that include the words believes, could, expects, anticipates, estimates, plans, projects, seeks, or similar expressions. We have based these forward-looking statements on our current expectations and projections about future events, based on the information currently available to us. These

forward-looking statements are subject to risks, uncertainties

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and assumptions, including those described under the heading **Risk Factors**, that may affect the operations, performance, development and results of our business. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date stated, or if no date is stated, as of the date of this Annual Report on Form 10-K.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or any other reason except as we may be required to do under applicable law. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this Annual Report on Form 10-K may not occur.

We operate in a very competitive and rapidly changing environment. New risk factors can arise and it is not possible for management to predict all such risk factors, nor can it assess the impact of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Given these risks and uncertainties, investors should not place undue reliance on forward-looking statements.

Investors should also be aware that while we do, from time to time, communicate with securities analysts, it is against our policy to disclose to them any material non-public information or other confidential commercial information. Accordingly, investors should not assume that we agree with any statement or report issued by any analyst irrespective of the content of the statement or report.

Furthermore, we have a policy against issuing or confirming financial forecasts or projections issued by others. Thus, to the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are not the responsibility of the Company.

Access to SEC Filings

Interested readers can access the Company's Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, through the U.S. Securities and Exchange Commission's website at www.sec.gov. These reports can be accessed free of charge.

Item 2. Properties

We occupy offices and facilities in various locations in California, Georgia, Maine, Puerto Rico and Tennessee. The following table summarizes our properties.

Facility/Location	Own/Lease	Description	Approximate Square Footage
Corporate Headquarters Carlsbad, California	Lease	Office Space	14,000
Footwear and Apparel			
Distribution Center Old Town, Maine	Own	Warehouse	75,000
Distribution Center Modesto, California	Lease	Office/Warehouse	20,000
Berkeley, California	Lease	Retail	2,400
Modesto, California	Lease	Retail	4,500
Dolgeville, New York	Own	Vacant Land	30 acres
Military Boot Operations			
Salinas, Puerto Rico	Lease	Cut and stitch plant	23,000
Lexington, Tennessee	Capital Lease	Finishing plant	76,000
Lexington, Tennessee	Lease	Distribution warehouse	30,000
Atlanta, Georgia	Lease	Office Space	6,300

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Our Lexington, Tennessee finishing plant and certain equipment at the plant are leased under a capital lease arrangement. Our capital lease payments are expected to be completed by December 31, 2005. We expect to exercise the \$100 purchase option at that time and terminate the lease.

We believe that our current facilities are adequate for our current and foreseeable future requirements.

Item 3. Legal Proceedings.

From time to time we are involved with legal proceedings, claims and litigation arising in the ordinary course of business. Except as discussed below, as of the date of this Annual Report on Form 10-K we are not a party to any pending material legal proceedings.

On June 21, 2004, we filed a lawsuit against Mark Tucker, Inc., Sears, Roebuck and Co., Saks Incorporated, Saks & Company, and Saks Fifth Avenue Enterprises, Inc. for infringement of our patent relating to the insole construction for our SoftWalk and Strol brand footwear. The suit was commenced in the United States District Court for the Southern District of California, and alleges that the defendants made and sold products in the United States that infringe our United States patent No. 6,675,501. We are requesting injunctive relief and the payment of damages and attorneys' fees. Each of the parties have responded to the complaint. We are presently conducting discovery with Mark Tucker and Sears. Saks Incorporated and related defendants have filed a motion to dismiss, which have opposed, and is scheduled to be heard by the Court on May 13, 2005.

Item 4. Submission Of Matters To A Vote Of Security Holders.

During the fourth quarter of our fiscal year, no matter was submitted to a vote of stockholders.

PART II**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

Our common stock trades on the American Stock Exchange under the symbol PXG. The following table sets forth for each calendar quarter the low and high closing sale prices per share of our common stock as reported on the American Stock Exchange for the applicable periods. These prices reflect our 2-for-1 stock split effective at the close of business on June 12, 2003.

	High	Low
Year Ended December 27, 2003:		
First Quarter	\$ 3.63	\$ 2.74
Second Quarter	\$ 5.19	\$ 3.51
Third Quarter	\$ 5.92	\$ 4.80
Fourth Quarter	\$ 7.49	\$ 5.80
Year Ended January 1, 2005:		
First Quarter	\$ 10.30	\$ 7.30
Second Quarter	\$ 13.20	\$ 8.49
Third Quarter	\$ 13.85	\$ 6.85
Fourth Quarter	\$ 7.88	\$ 6.43

At March 15, 2005, we had approximately 876 holders of record (including Cede & Co., the nominee for the Depository Trust Company, a registered clearing agency). We believe that the number of beneficial owners of our common stock on that date was substantially greater.

We do not pay cash dividends on our capital stock. We do not anticipate paying cash dividends in the foreseeable future. We currently anticipate that we will retain all future earnings for use in funding the

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expansion of our business and general corporate purposes. In addition, our credit facility restricts our ability to declare or pay dividends without the bank's consent. Any future determination as to the payment of dividends will be subject to applicable limitations, will be at the discretion of our board of directors and will depend on our results of operations, financial condition, capital requirements and other factors deemed relevant by our board of directors. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources.

Securities Authorized for Issuance Under Equity Compensation Plans

Information about the Company's equity compensation plans at January 1, 2005 is as follows:

Equity Compensation Plan Information

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity comp plans (excluding(a)) (c)
Equity compensation plans approved by stockholders ⁽¹⁾	987,000	\$ 7.70	600,000
Equity compensation plans not approved by stockholders ⁽²⁾	448,000	\$ 3.51	
Total	1,435,000	\$ 6.39	600,000

(1) Consists of the following plans: 2001 Long-Term Incentive Plan and the 1995 Stock Incentive Plan. No shares are available for grant under the 1995 Stock Incentive Plan at January 1, 2005. The 2001 Long-Term Incentive Plan permits the award of stock options, restricted stock and various other stock-based awards.

(2) Consists of a) options to purchase 398,000 shares of common stock granted to James R. Riedman and Riedman Corporation at a weighted average exercise price of \$2.07 per share in connection with financial guaranties and loans granted to us. See Note 10 to our Consolidated Financial Statements as of January 1, 2005; and b) outstanding underwriter warrants to purchase up to 50,000 shares at an exercise price of \$15.00 per share issued in July 2004 in connection with our follow-on public offering.

We did not make any repurchases of our common stock during the fourth quarter of fiscal 2004.

Item 6. Selected Financial Data

The historical consolidated statements of operations data for the years ended December 31, 2002, December 27, 2003 and January 1, 2005, and the historical consolidated balance sheet data as of December 27, 2003 and January 1, 2005, have been derived from our historical consolidated financial statements audited by Deloitte & Touche LLP, an independent registered public accounting firm, which consolidated financial statements and report of such firm are included elsewhere in this Annual Report on Form 10-K. The historical consolidated statements of operations data for the years ended December 31, 2000 and 2001, and the historical balance sheet data as of December 31, 2000, 2001

and 2002, have been derived from our audited historical consolidated financial statements that are not included in this Annual Report on Form 10-K.

The financial data in the following table was impacted by our 2000 acquisition of the Penobscot Shoe Company and its Trotters brand, our 2001 sale of our slipper brands, our 2003 acquisitions of H.S. Trask and Royal Robbins and our 2004 acquisition of Altama. As a result of the slipper brands divestiture, we recognized a \$1.2 million gain in the fiscal year ended December 31, 2001 and experienced lower net sales in fiscal 2002. For our two acquisitions in fiscal 2003, we paid a total purchase price of \$9.5 million in cash, issued 71,889 shares of common stock and agreed to pay Royal Robbins stockholders a potential earnout if certain financial thresholds are achieved. In 2004, we made the first of two possible payments under the earnout which

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totaled \$2.0 million. For our acquisition of Altama in 2004, we paid a total purchase price of \$38 million in cash, issued 2,500,000 shares of common stock in a concurrent public offering, issued 196,967 shares of common stock to Altama's sole stockholder and agreed to pay Altama's sole stockholder \$2.0 million over five years for a covenant not to compete and a potential earnout if certain financial thresholds are achieved.

Historical results are not necessarily indicative of future results. The following information should be read in conjunction with our consolidated financial statements and the related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations, which are included elsewhere in this Annual Report on Form 10-K.

Fiscal Years Ended

December 31, December 31, December 31, December 27, January 1,
2000⁽¹⁾ 2001⁽²⁾ 2002⁽³⁾ 2003⁽⁴⁾⁽⁵⁾ 2005⁽⁶⁾

(In thousands, except share, per share data and stock price)

**Consolidated Statements
of Operations Data**

Net sales	\$ 33,179	\$ 46,851	\$ 36,161	\$ 39,077	\$ 76,386
Cost of goods sold	22,233	31,439	22,397	22,457	44,802
Gross profit	10,946	15,412	13,764	16,620	31,584
Operating expenses:					
Selling, general and administrative expenses	9,705	11,917	9,661	12,696	25,610
Other expense, net	1,016	375	442	1,377	113
Total operating expenses	10,721	12,292	10,103	14,073	25,723
Operating income	225	3,120	3,661	2,547	5,861
Interest expense	1,363	1,683	751	620	888
(Loss) earnings before income taxes	(1,138)	1,437	2,910	1,927	4,973
Income tax (benefit) expense	(456)	67	1,207	986	1,990
Net (loss) earnings	\$ (682)	\$ 1,370	\$ 1,703	\$ 941	\$ 2,983
Net (loss) earnings per share ⁽⁷⁾					
Basic	\$ (0.22)	\$ 0.44	\$ 0.50	\$ 0.24	\$ 0.51
Diluted	\$ (0.22)	\$ 0.41	\$ 0.45	\$ 0.22	\$ 0.48
Weighted average common shares outstanding					
Basic	3,141,190	3,137,688	3,418,468	3,963,382	5,793,920
Diluted	3,141,190	3,444,042	3,781,634	4,350,132	6,277,222

	Years Ended				
	Dec. 31 2000	Dec. 31 2001	Dec. 31 2002	Dec. 27 2003	Jan. 1 2005
(In thousands)					
Consolidated Balance Sheet Data					
Cash and cash equivalents	\$ 1	\$ 1,161	\$ 1,265	\$ 1,058	\$ 694
Working capital	(1,607)	5,358	8,812	13,423	29,559
Total assets	38,424	27,577	18,954	36,411	91,054
Contingent liability				1,942	
Total bank debt	18,926	14,829	3,000	12,082	26,607
Total stockholders' equity	\$ 5,898	\$ 7,452	\$ 10,112	\$ 14,987	\$ 49,686

- (1) Includes \$808,000 of expenses associated with the Company's headquarters and distribution operation relocation from Dolgeville, New York to the newly acquired facilities in Old Town, Maine. Costs

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associated with this relocation included severance, moving expenses and closing facilities. In addition, an impairment loss of \$208,000 was recognized in 2000.

- (2) The net amount of \$375,000 in Other expense, net consists primarily of a \$1.2 million gain in connection with the divestiture of our slipper business, and a \$1.7 million loss incurred in connection with the termination of the Penobscot Shoe Company pension plan and a net gain on the sale of property of \$142,000.
- (3) The net amount of \$442,000 in Other expense, net consists primarily of losses on dispositions and write-offs on asset sales.
- (4) The net amount of \$1,377,000 in Other expense, net consists primarily of \$394,000, or \$0.06 per diluted share, of non-capitalized acquisition expenses, \$354,000, or \$0.05 per diluted share, associated with the relocation of our corporate offices from Old Town, Maine to Carlsbad, California, litigation costs and expenses totaling \$733,000, or \$0.17 per diluted share, associated with the dissenting stockholders appraisal proceeding resulting from our fiscal 2000 acquisition of Penobscot Shoe Company, and a \$163,000, or \$0.02 per diluted share, write-off of a non-trade receivable. These amounts were offset partially by an excise tax refund totaling \$285,000, or \$0.07 per diluted share, which was not taxable, associated with the fiscal 2001 termination of the Penobscot pension plan. Interest expense includes \$376,000, or \$0.05 per diluted share, of interest expense related to the settlement of the dissenting stockholder's appraisal proceeding. On an aggregate basis, these amounts reduced our fiscal 2003 per diluted share earnings by \$0.28.
- (5) In October 2003, we acquired Royal Robbins in a stock purchase for an aggregate purchase price of \$6.8 million, which included the issuance of 71,889 shares of common stock valued at \$500,000, plus potential contingent earnout cash payments through May 2005. In August 2003, we acquired H.S. Trask for an aggregate purchase price of \$6.4 million which included the issuance of 699,980 shares of common stock valued at \$3.2 million. In connection with these acquisitions \$109,000 or \$0.02 per diluted share of acquisition related expenses were not capitalized.
- (6) On July 19, 2004, we purchased all of the outstanding capital stock of Altama Delta Corporation for approximately \$37.8 million plus non-competition payments totaling \$2.0 million and payable over five years. The price included the issuance of 196,967 shares of common stock valued at \$2.5 million. We also incurred approximately \$740,000 in acquisition-related expenses which increased the net purchase price. For a further discussion of the Altama acquisition see Management's Discussion and Analysis of Financial Condition and Results of Operations Overview and Altama Acquisition.
- (7) Per share data has been adjusted to reflect the 2-for-1 stock split effective at the close of business on June 12, 2003. Phoenix Footwear Group, Inc.'s Retirement Savings Partnership Plan, a 401(k) plan, held 796,441 shares of our common stock as of January 1, 2005. A total of 478,514 shares were not allocated as of January 1, 2005 and were classified as treasury shares for accounting purposes, but are outstanding for voting purposes and other legal purposes.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the historical consolidated financial statements and the related notes and the other financial information included elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of any number of factors, including those set forth under Factors That May Affect Forward Looking Statements and under other captions contained elsewhere in this Annual Report on Form 10-K.

Effective January 1, 2003, we changed our accounting year to a 52/53 week period. Our annual accounting period ends on the Saturday nearest to December 31. In this Annual Report on Form 10-K we refer to the fiscal year ended December 31, 2002 as fiscal 2002, to the fiscal year ended December 27, 2003 as fiscal 2003, to the fiscal year ended

January 1, 2005 as fiscal 2004, and to the fiscal year ending December 31, 2005 as fiscal 2005. The change in fiscal year end did not materially impact our fiscal 2004 results of operations or year-over-year comparisons.

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In this presentation we discuss pro forma organic net sales growth in our footwear and apparel segment, which is a non-GAAP financial measure of reported sales based on our pro forma net sales for this segment both including and excluding the brands we acquired in fiscal 2003. Management believes that discussing pro forma organic net sales in this manner provides a better understanding of our net sales performance and trends than reported revenue because it allows for more meaningful comparisons of current-period revenue to that of prior periods on a comparable basis. SEC rules require supplemental explanation and reconciliation, which is provided at Results of Operations Fiscal 2004 Compared to Fiscal 2003 Footwear and Apparel Business Reconciliation.

Overview

We are a men's and women's footwear and apparel company. We design, develop and market branded dress and casual footwear and apparel and design, manufacture and market military specification (mil-spec) and commercial combat and uniform boots.

In our footwear and apparel segment, we sell over 100 different styles of footwear and over 250 different styles of apparel products. By emphasizing traditional style, quality and fit in this segment, we believe we can better maintain a loyal consumer following that is less susceptible to fluctuations due to changing fashion trends and consumer preferences. As a result, a significant number of our product styles carry over from year-to-year. In addition, our design and product development teams seek to create and introduce new products and styles that complement these longstanding core products, are consistent with our brand images and meet our high quality standards.

We entered the military boot segment in fiscal 2004 through our acquisition of Altama Delta Corporation on July 19, 2004. In our military boot segment, we sell a total of 18 boot models under our Altama brand for the military and commercial markets. We believe that the majority of products under this brand are not sensitive to fashion risk.

During the last two quarters of fiscal 2003, we acquired H.S. Trask & Co., a men's footwear company, and Royal Robbins, Inc., an apparel company. Our fiscal 2003 and fiscal 2004 acquisitions added to our portfolio of brands, diversified our product offerings and customer base and provided a base for significant additional revenues in the future. Since making our acquisitions, we have integrated their operations with our infrastructure and sought to eliminate duplicative overhead and operational inefficiencies. The increase in revenues and operating expenses during fiscal 2004 as compared to fiscal 2003 primarily relates to our newly acquired brands.

To fund the Altama acquisition, we conducted a follow on public offering of our common stock which was consummated on July 19, 2004. In the offering we issued 2,500,000 shares at the \$12.50 per share offering price, resulting in net proceeds, after deducting the underwriters fees and transaction costs, of approximately \$28.4 million. In addition to these proceeds we utilized approximately \$10.0 million of additional borrowings under our amended credit facility to finance the cash portion of the purchase price for the Altama acquisition, to refinance Altama's funded indebtedness and to pay related transaction fees and expenses.

We intend to continue to pursue acquisitions of footwear, apparel and related products companies that we believe could complement or expand our business, or augment our market coverage. We seek companies or product lines that we believe have consistent historical cash flow and brand growth potential and can be purchased at a reasonable price. We also may acquire businesses that we feel could provide us with important relationships or otherwise offer us growth opportunities. We plan to fund our future acquisitions through bank financing, seller debt or equity financing and public or private equity financing. Although we are actively seeking acquisitions that will expand our existing brands, as of the date of this we have no agreements with respect to any such acquisitions, and there can be no assurance that we will be able to identify and acquire such businesses or obtain necessary financing on favorable terms.

Table of Contents**Altama Acquisition**

On July 19, 2004, we purchased all of the outstanding capital stock of Altama Delta Corporation for approximately \$37.8 million, plus an earnout payment of \$2.0 million that is subject to Altama meeting certain sales requirements. As part of the transaction, we refinanced Altama's indebtedness of approximately \$1.7 million and incurred approximately \$740,000 in acquisition related expenses which increased the net purchase price. Payment of the purchase price at closing was made by delivery of \$35.5 million in cash, and 196,967 shares of common stock valued at \$2.5 million.

Under the terms of the stock purchase agreement, we agreed to pay W. Whitlow Wyatt, the former owner of Altama, \$2.0 million in consideration for a five-year covenant-not-to-compete and other restrictive covenants. We also entered into a two-year consulting agreement with Mr. Wyatt which provides for an annual consulting fee of \$100,000.

Altama has manufactured military footwear for the U.S. Department of Defense, or DoD, for 36 consecutive years. Altama also produces combat and uniform boots for commercial markets. During 2004, Altama operated under a surge option pursuant to which it sold boots to the DoD in excess of the initial maximum amount awarded under its DoD contract. In September 2004, the DoD exercised the first option term under its contract with Altama, and at that time increased Altama's portion of the contract volume from 20% to 30%. The first year option term runs from October 2004 through September 2005. The maximum pairs that the DoD can order under this option is less than that of the base contract year, as a result of the discontinuance of the all leather-combat boot. We have been advised that the DoD does not intend to issue orders in excess of the maximum award during this first option year. Therefore, we will not be operating at surge production rates and our net sales under the Altama brand are expected to be lower in fiscal 2005 than in fiscal 2004.

Altama's business generates lower gross margins than ours historically has generated. As a result, the acquisition caused our gross margin to be lower in fiscal 2004 and we expect this trend to continue. However, Altama's selling, general and administrative expenses as a percentage of net sales has been historically lower than ours. Therefore, our overall operating margin did not significantly change as a result of the acquisition.

As a result of its DoD business, Altama has different working capital requirements and lower inventory risks than we do. For its DoD business, Altama produces its inventory only upon receipt of orders under specific contracts. After completion of the manufacturing process, DoD orders are reviewed for quality assurance, and upon approval Altama bills the DoD.

With the acquisition of Altama our principal operations have been classified into two business segments: footwear and apparel and military boot operations. See Note 13 to Financial Statements.

Results of Operations

The following table sets forth selected consolidated operating results for each of the last three fiscal years, presented as a percentage of net sales.

	Fiscal Year Ended		
	December 31, 2002	December 27, 2003	January 1, 2005
Net sales	100%	100%	100%
Costs of goods sold	62%	57%	59%
Gross profit	38%	43%	41%
Selling, general and administrative and other expenses	28%	36%	33%
Operating income	10%	7%	8%
Interest expense	2%	2%	1%
Earnings before income taxes	8%	5%	7%
Income tax expense	3%	3%	3%

Net earnings	5%	2%	4%
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Table of Contents**Fiscal 2004 Compared to Fiscal 2003*****Consolidated Net Sales***

Consolidated net sales for fiscal 2004 were \$76.4 million compared to \$39.1 million for fiscal 2003, representing a 95% increase. Of this increase, \$23.6 million is attributable to acquired brand revenue associated the H.S. Trask and Royal Robbins brand acquisitions that occurred during the second half of 2003 and \$13.6 million was attributable to acquired brand revenue associated with the Altama brand acquisition that occurred during the third quarter of fiscal 2004. Our footwear and apparel segment generated 5.5% year-over-year pro forma organic net sales growth during fiscal 2004 as compared to pro forma net sales for these brands during fiscal 2003.

Consolidated Gross Profit

Consolidated gross profit for fiscal 2004 increased 90% to \$31.6 million as compared to \$16.6 million for the comparable prior year period. The increase in gross profit is due to our 2003 and 2004 acquisitions. Gross profit as a percentage of net sales decreased to 41% compared to 43% in the prior year period. The decrease in gross profit margin was primarily related to increased mark downs and close-out activity and the inclusion of the Altama brand gross margins which generate lower gross margins than our other branded products.

Consolidated Operating Expenses

Consolidated selling, general and administrative, or SG&A expenses were \$25.6 million, or 34% of net sales, for fiscal 2004 as compared to \$12.7 million or 32% of net sales for fiscal 2003. This dollar increase was primarily related to increased operating costs associated with supporting a higher sales volume, our recently acquired brands and increased sales, design and management compensation expenses. We anticipate that our fiscal 2005 SG&A expenses will increase as a result of our Altama acquisition.

Consolidated Other expense net was \$113,000 for the fiscal 2004 and consisted primarily of expenses that could not be capitalized in connection with discontinued acquisition activities. Our Other expense net of \$1.4 million for fiscal 2003 consisted primarily of \$733,000 in litigation expenses incurred with the dissenting Penobscot stockholders settlement, \$394,000 in non-capitalizable acquisition costs, \$354,000 in expenses related to our corporate headquarters relocation and the write-off of non-trade receivables totaling \$163,000. These expenses were partially offset by an excise tax refund of \$285,000 associated with the 2001 Penobscot pension plan reversion.

Consolidated Interest Expense

Consolidated interest expense for fiscal 2004 was \$888,000 as compared to \$620,000 in fiscal 2003. The increase in interest expense during fiscal 2004 was a result of increased acquisition and working capital indebtedness associated with our 2003 and 2004 brand acquisitions and higher interest rates. In addition, fiscal 2003 results included interest charges totaling \$376,000 associated with the dissenting stockholders litigation settlement. We expect our consolidated interest expense to increase during fiscal 2005 due to our additional acquisition related borrowings and the temporary increase in our line during the first quarter of fiscal 2005.

Consolidated Income Tax Provision

We recorded income tax expense for fiscal 2004 of \$1,990,000 as compared to \$986,000 for fiscal 2003. Our effective tax rate during fiscal 2004 was 40% and it is anticipated that the effective tax rate going forward will be 40%. Our effective tax rate in fiscal 2003 was 51% and was primarily associated with the Penobscot litigation settlement, which was substantially non-deductible for income tax purposes. Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities, for financial reporting purposes, and the amounts used for income tax purposes.

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Consolidated Net Earnings

Our net earnings for fiscal 2004 were \$3.0 million as compared to \$941,000 for fiscal 2003. The improvement in net earnings is primarily due to our increased net sales from the fiscal 2003 and 2004 acquisitions, along with successful integration of these new brands and our continuing expense reduction efforts. Our net earnings per diluted share were \$0.48 for fiscal 2004 as compared to \$0.22 per diluted share for fiscal 2003. This reflects our issuance of 2.5 million shares of common stock with our July 2004 follow-on public offering, and the shares issued in the Altama acquisition to Altama's sole stockholder.

Footwear and Apparel Business

Net Sales

Net sales for fiscal 2004 were \$62.7 million compared to \$39.1 million for fiscal 2003, representing a 60% increase. Of this increase, \$23.6 million is attributable to acquired brand revenue associated with the H.S. Trask and Royal Robbins brand acquisitions that occurred during the second half of 2003. Our Trotters, SoftWalk, H.S. Trask, and Royal Robbins brands on a combined basis generated 5.5% year-over-year pro forma organic net sales growth based on \$59.5 million in pro forma net sales for fiscal 2003. This increase was primarily attributable to an expanded fall and winter product line for our Royal Robbins brand and an increase in product sell through along with a larger customer base for our SoftWalk brand. These increases were partially offset by a decrease in our H.S. Trask brand sales as a result of a complete product repositioning and redesign effort during fiscal 2004 and