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CALLOWAYS NURSERY INC

Form 10-Q

August 14, 2001

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2001

Commission File No. 0-19305

CALLOWAY'S NURSERY, INC.

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation or organization)

75-2092519
(IRS Employer
Identification Number)

4200 Airport Freeway
Fort Worth, Texas 76117-6200
817.222.1122

(Address, including zip code, of principal executive
offices and Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

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

Title -----	Shares Outstanding as of July 31, 2001 -----
Common Stock, par value \$.01 per share	6,196,530

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CALLOWAY'S NURSERY, INC.

FORM 10-Q

JUNE 30, 2001

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FORWARD-LOOKING STATEMENTS OR INFORMATION

This Form 10-Q Report contains forward-looking statements. We are including this statement for the express purpose of providing Calloway's the protections of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995 with respect to all forward-looking statements. Several important factors, in addition to the specific factors discussed in connection with such forward-looking statements individually, could affect future results and could cause those results to differ materially from those expressed in the forward-looking statements contained in this Report.

Our expected future results, products and service performance or other non-historical facts are forward-looking and reflect our current perspective of existing trends and information. These statements involve risks and uncertainties that cannot be predicted or quantified and, consequently, actual results may differ materially from those expressed or implied by such forward-looking statements. Such risks and uncertainties include, among others, the seasonality of our business, geographic concentration, the impact of weather and other growing conditions, the ability to manage growth, the impact of competition, the ability to obtain future financing, government regulations, market risks associated with variable-rate debt, the anticipated costs and benefits of discontinuing certain operations, and other risks and uncertainties defined from time to time in our Securities and Exchange Commission filings.

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Therefore, each reader of this report is cautioned to consider carefully these factors as well as the specific factors discussed with each forward-looking statement in this Report and disclosed in our filings with the Securities and Exchange Commission as such factors, in some cases, have affected, and in the future (together with other factors) could affect, our ability to implement our business strategy and may cause actual results to differ materially from those contemplated by the statements expressed in this Report.

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PART 1. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(IN THOUSANDS)

ASSETS

	JUNE 30, 2001	SEPTEMBER 30, 2000	JUNE 30, 2000
	-----	-----	-----
Cash and cash equivalents	\$ 2,667	\$ 413	\$ 3,643
Accounts receivable	207	250	114
Inventories	6,145	5,843	5,451
Prepays and other assets	245	316	143
Deferred income taxes -- current	1,541	--	--
Current assets of discontinued operations	2,321	6,907	6,980
	-----	-----	-----
Total current assets	13,126	13,729	16,331
	-----	-----	-----
Property and equipment, net	14,056	14,228	14,345
Goodwill, net	767	848	875
Deferred income taxes -- noncurrent	1,297	1,348	1,369
Other assets	273	187	193
Noncurrent assets of discontinued operations	629	637	640
	-----	-----	-----
Total assets	\$ 30,148	\$ 30,977	\$ 33,753
	=====	=====	=====

LIABILITIES AND SHAREHOLDERS' EQUITY

Accounts payable	\$ 3,630	\$ 3,202	\$ 4,276
Accrued expenses	1,335	1,672	1,929
Accrued income taxes	1,078	1,518	2,159
Notes payable, current	--	55	--
Current portion of long-term debt	721	555	780
Deferred income taxes, current	--	118	165
Current liabilities of discontinued operations	1,572	1,049	583
	-----	-----	-----
Total current liabilities	8,336	8,169	9,892
Deferred rent payable	958	1,056	1,132
Long-term debt, net of current portion	9,883	9,870	9,755

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Total liabilities	19,177	19,095	20,779
Commitments and contingencies			
Non-voting preferred stock, with mandatory redemption provisions	2,102	1,877	1,808
Shareholders' equity:			
Voting convertible preferred stock	--	--	--
Preferred stock	--	--	--
Common stock	64	62	62
Additional paid-in capital	9,526	9,288	9,163
Retained earnings	675	2,051	3,337
	10,265	11,401	12,562
Less: Treasury stock, at cost	(1,396)	(1,396)	(1,396)
Total shareholders' equity	8,869	10,005	11,166
Total liabilities and shareholders' equity	\$ 30,148	\$ 30,977	\$ 33,753

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

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(AMOUNTS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	NINE MONTHS ENDED JUNE 30,		THREE MONTHS JUNE
	2001	2000	2001
Net sales	\$ 37,586	\$ 38,276	\$ 20,251
Cost of goods sold	18,578	18,705	9,491
Gross profit	19,008	19,571	10,760
Operating expenses	10,140	10,350	3,759
Occupancy expenses	1,943	2,104	656
Advertising expenses	1,301	1,211	577
Depreciation and amortization	676	669	208
Interest expense	878	770	260
Interest income	(30)	(58)	(25)
Total expenses	14,908	15,046	5,435
Income from continuing operations before income taxes	4,100	4,525	5,325
Income taxes	1,577	1,720	2,006

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Income from continuing operations	2,523	2,805	3,319
	-----	-----	-----
Discontinued wholesale operations:			
Income (loss) from discontinued operations (net of income taxes (benefit) of (\$371), \$45, (\$346), and \$310, respectively)	(647)	79	(607)
Loss on disposal of Wholesale operations (net of income tax benefit of \$1,736)	(3,027)	--	(3,027)
	-----	-----	-----
	(3,674)	79	(3,634)
	-----	-----	-----
Net income (loss)	(1,151)	2,884	(315)
Accretion of preferred stock	(225)	(192)	(75)
Retirement of preferred stock	--	115	--
	-----	-----	-----
Net income (loss) attributable to common shareholders	\$ (1,376)	\$ 2,807	\$ (390)
	=====	=====	=====
Weighted average number of common shares outstanding			
Basic	6,074	5,789	6,136
Diluted	6,074	5,930	6,136
Basic net income (loss) per common share:			
Income from continuing operations	\$.38	\$.47	\$.53
Discontinued operations	(.61)	.01	(.59)
	-----	-----	-----
Net income (loss)	\$ (.23)	\$.48	\$ (.06)
	=====	=====	=====
Diluted net income (loss) per common share:			
Income from continuing operations	\$.38	\$.46	\$.53
Discontinued operations	(.61)	.01	(.59)
	-----	-----	-----
Net income (loss)	\$ (.23)	\$.47	\$ (.06)
	=====	=====	=====

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

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(IN THOUSANDS)

	NINE MONTHS ENDED JUNE 30,	
	2001	2000
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ (1,151)	\$ 2,884

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Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Loss from discontinued operations	3,674	--
Depreciation and amortization	676	669
Net change in operating assets and liabilities	(886)	1,255
	-----	-----
Net cash provided by operating activities	2,313	4,729
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES		
Additions to property and equipment	(423)	(1,741)
	-----	-----
Net cash used for investing activities	(423)	(1,741)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of common stock	240	239
Retirement of preferred stock	--	(159)
Borrowings on debt	8,017	3,100
Repayments of debt	(7,893)	(2,589)
	-----	-----
Net cash provided by financing activities	364	591
	-----	-----
NET INCREASE IN CASH AND CASH EQUIVALENTS	2,254	3,581
Cash and cash equivalents at beginning of period	413	62
	-----	-----
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 2,667	\$ 3,643
	=====	=====

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

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

These interim unaudited consolidated financial statements were prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). In management's opinion, all adjustments considered necessary for a fair presentation of the financial position at June 30, 2001, and the results of operations for the three-month and nine-month periods ended June 30, 2001 and 2000, and cash flows for the nine-month periods ended June 30, 2001 and 2000 have been made. Such adjustments are of a normal recurring nature, except for those related to the discontinued operations as discussed in Note 7.

Because of seasonal and other factors, the results of operations for the three-month and nine-month periods ended June 30, 2001 and cash flows for the nine-month period ended June 30, 2001 are not necessarily indicative of expected results of operations and cash flows for the fiscal year ending September 30,

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	month period ended June 30, 2001 -----	month period ended June 30, 2000 -----	month period ended June 30, 2001 -----	month period ended June 2000 -----
SALES				
From external customers				
Retail	\$ 37,482	\$ 38,199	\$ 20,216	\$ 17,8
Growing and Wholesale	5,391	7,963	2,374	3,0
Totals	42,873	46,162	22,590	20,8
From other operating segments				
Retail	--	--	--	1,2
Growing and Wholesale	2,166	2,484	1,288	1,2
Totals	2,166	2,484	1,288	1,2
Less: wholesale sales	(5,287)	(7,886)	(2,339)	(2,9
Less: elimination of intersegment sales	(2,166)	(2,484)	(1,288)	(1,2
Total consolidated net sales	\$ 37,586 =====	\$ 38,276 =====	\$ 20,251 =====	\$ 17,9 =====
INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES				
Retail	\$ 4,126	\$ 4,571	\$ 4,863	\$ 4,0
Growing and Wholesale	(1,044)	78	(491)	1,0
Totals	3,082	4,649	4,372	5,1
Loss (income) from discontinued wholesale operations (before income taxes)	1,018	(124)	953	(8
Total consolidated income from continuing operations before income taxes	\$ 4,100 =====	\$ 4,525 =====	\$ 5,325 =====	\$ 4,2 =====

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CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	June 30, 2001 -----	June 30, 2000 -----
TOTAL ASSETS		
Retail	\$ 22,053	\$ 22,139
Growing and wholesale	11,192	19,327
Less: assets of discontinued wholesale operations	(2,950)	(7,620)
Less: elimination of profit on intersegment sales	(147)	(93)
Totals	\$ 30,148	\$ 33,753

5. STOCK OPTION PLAN

In February 2001 the Company's shareholders approved its 2000 Stock Option Plan (the "2000 Plan"). The 2000 Plan provides for the awarding of incentive and non-qualified stock options to employees, and is administered by the Compensation Committee of the Board of Directors, which consists entirely of independent directors. 302,000 shares of common stock have been reserved for issuance under the 2000 Plan. An aggregate of 2,267,000 shares of common stock have been reserved for issuance under all of the Company's stock option plans.

6. LONG TERM DEBT

In April 2001 the Company entered into a note payable to a financial institution for \$1,100,000, using \$1,040,000 of the proceeds to reduce the balance of a note payable to another financial institution. The new note is collateralized by certain real estate and requires payments, including interest, of approximately \$ 114,000 annually for a term of 20 years. The interest rate is 8.5% fixed. The note matures in April 2021. The note payable and applicable real estate relate to the WLD wholesale operations, which are being sold, as discussed in Note 7.

7. SUBSEQUENT EVENT -- DISCONTINUED OPERATIONS AND ASSETS HELD FOR SALE

On August 7, 2001 the Company adopted a formal plan to dispose of the wholesale operations, which had been a part of its Wholesale and Growing segment. The Company plans to exit its wholesale operations by the end of November 2001. Specifically, the Company will cease in an orderly fashion production and marketing of plants and related products grown or purchased for sale to wholesale customers, including other nursery retailers and landscape contractors. The wholesale operation includes the wholesale growing operations of Turkey Creek Farms as well as the wholesale landscape distribution centers ("WLD") in Austin and Houston. At Turkey Creek Farms, the Company will exclusively grow plants for sale at its retail stores. The adopted disposal plan includes: (i) the sale of the Turkey Creek Farms wholesale inventories to unaffiliated customers, and (ii) the active marketing for sale of the WLD operations.

The Company has incurred operating losses and negative cash flows in the wholesale operations for most of the last two fiscal years. The continued pressure from lower cost wholesalers has impacted the profitability and competitive position of these operations. The Company has concluded that market conditions today and for the foreseeable future are such that these operations are likely to remain uncompetitive. Additionally, incremental future investments would not generate sufficient income to recover the cost of such investments.

CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Company recorded a loss on disposal of discontinued operations of approximately \$3.0 million (net of income taxes) in the quarter ended June 30, 2001 to cover the expected cash and non-cash costs of the discontinued operations. The loss includes the write down to estimated net realizable value of the investment in facilities and equipment, inventory, and accounts receivable, as well as the accrual of anticipated operating losses during the

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period after the date the disposal plan was adopted, through the date the disposition is completed.

Prior to this decision, the Company grew plants for sale to external customers in addition to plants grown for sale in its retail stores. The Company intends to grow a greater amount of plants that are solely for sale in its retail stores.

Following is a summary of the asset and liabilities of the discontinued wholesale operations as of the applicable periods (amounts in thousands):

	June 30, 2001 -----	September 30, 2000 -----	June 30, 2000 -----
ASSETS			
Accounts receivable	\$ 887	\$ 818	\$1,167
Inventories	1,434	6,089	5,813
	-----	-----	-----
Current assets of discontinued operations	\$2,321	\$6,907	\$6,980
	=====	=====	=====
Property and equipment, net	\$ 629	\$ 637	\$ 640
	-----	-----	-----
Noncurrent assets of discontinued operations	\$ 629	\$ 637	\$ 640
	=====	=====	=====
LIABILITIES			
Accounts payable	\$ 615	\$ 799	\$ 491
Accrued expenses	957	250	92
	-----	-----	-----
Current liabilities of discontinued operations	\$1,572	\$1,049	\$ 583
	=====	=====	=====

As discussed in Note 6, long-term debt (including current portion) of \$1,100,000 that is collateralized by the WLD real property is included in the condensed consolidated balance sheet as of June 30, 2001. That note payable was entered into in April 2001 with the proceeds being used to reduce the amount outstanding on a note payable to another financial institution. Prior to April 2001 there was no separate indebtedness related only to the WLD real property. A portion of the proceeds from the sale of the WLD real property will be used to pay off the \$1,100,000 note payable referred to above.

CALLOWAY'S NURSERY, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Following is a summary of the operating results of the discontinued wholesale operations for the applicable periods (amounts in thousands):

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	Nine month period ended June 30, 2001 -----	Nine month period ended June 30, 2000 -----	Three month period ended June 30, 2001 -----	Three month period ended June 30, 2000 -----
Sales	\$ 5,287	\$ 7,886	\$ 2,339	\$ 2,95
Cost of goods sold	4,591	5,395	2,657	1,46
Gross profit (loss)	696	2,491	(318)	1,48
Operating expenses	1,400	2,092	529	55
Occupancy expenses	266	240	84	7
Advertising expenses	6	8	2	
Depreciation and amortization	40	27	20	
Interest expense	2	--	--	
Total expenses	1,714	2,367	635	63
Income (loss) from discontinued operations before income taxes	(1,018)	124	(953)	85
Income taxes (benefit)	(371)	45	(346)	31
Income (loss) from discontinued operations	(\$ 647)	\$ 79	(\$ 607)	\$ 54

The Company recorded a loss on disposal of discontinued operations (net of income tax) of \$3,027,000 for the nine-month and three-month periods ended June 30, 2001. The loss included the expected loss on the disposal of the Turkey Creek Farms wholesale inventory, partially offset by expected gains on the sale of other assets, and estimated income tax benefits of \$1,736,000.

The discontinuance of the wholesale operations has not caused the Company to be in violation of its various bank covenants. However, the Company could require a waiver of the debt coverage ratio (a ratio comparing net income plus depreciation and amortization to current portion of long-term debt) at some time during fiscal 2002. In the event this occurs, the Company will seek a waiver from its bank lender.

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

RESULTS OF OPERATIONS

INTRODUCTION

In September 1999 we completed the Acquisition of Cornelius Nurseries, Inc. and affiliated companies (the "Cornelius Acquisition"). The results of operations for fiscal 2000 and fiscal 2001 include the Cornelius Acquisition.

On August 7, 2001 the Company adopted a formal plan to dispose of the wholesale operations, which had been a part of its Wholesale and Growing segment (see Note

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7 to Financial Statements). Accordingly, the following discussion of results of operations has been separated into (i) Continuing Operations and (ii) Discontinued Operations.

CONTINUING OPERATIONS

QUARTER ENDED JUNE 30, 2001 COMPARED WITH QUARTER ENDED JUNE 30, 2000

(Amounts in millions, except per share amounts)

THIRD QUARTER HIGHLIGHTS (UNAUDITED)	Fiscal 2001	Fiscal 2000
Consolidated net sales	\$20.3	\$17.9
Retail segment sales	20.2	17.9
Growing segment sales	1.4	1.2
Less: internal sales	\$(1.3)	\$(1.2)
Sales increase (decrease)	13%	19%
Same-store sales increase (decrease)	15%	(7%)
Number of retail stores (end of quarter)	20	21
Gross profit margin	53%	55%
Income from continuing operations before income taxes	\$ 5.3	\$ 4.3
Income from continuing operations per share (basic)	\$.53	\$.45
Cash flows from operations	\$ 5.7	\$ 2.8
Retail store inventories	\$ 4.3	\$ 4.1
Growing inventories	\$ 1.8	\$ 1.4
Current ratio	1.57	1.65
Property, plant and equipment (net)	\$14.1	\$14.3
Long-term debt (including current portion)	\$10.6	\$10.5

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CONSOLIDATED NET SALES increased 13%. Same-store sales (sixteen Calloway's stores in Dallas-Fort Worth and three Cornelius stores in Houston) increased 15%. The increase in Retail sales was primarily attributable to greater consumer demand in the Company's market areas for the April - June period (offsetting reduced demand during the January - March period).

GROSS MARGIN was 53% for the fiscal 2001 quarter compared to 55% for the fiscal 2000 quarter. The reduction was primarily related to an increase in promotional pricing coordinated with increased advertising during the April - May period that helped fuel the sales increase achieved for the quarter.

OPERATING EXPENSES declined 4%, from approximately \$3.9 million for the fiscal 2000 quarter to approximately \$3.8 million for the fiscal 2001 quarter. The decline was primarily due to lower bonus expenses. Bonuses are tied to

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improvements in profitability and related measures. The fiscal 2000 period had significant improvement in most of those measures for most units, while results for the fiscal 2001 period did not improve for most units.

ADVERTISING EXPENSES increased 19%, from \$485,000 for the fiscal 2000 quarter to \$577,000 for the fiscal 2001 quarter. The timing of expenditures was adjusted to allocate more to the later part of the spring season due to poor weather conditions that had a negative impact on consumer demand during the earlier part of the spring season.

OCCUPANCY EXPENSES declined 8% from \$710,000 for the fiscal 2000 quarter to \$656,000 for the fiscal 2001 quarter. The reduction was primarily due to lower estimated property taxes for fiscal 2001 than had been expected for the comparable period in fiscal 2000.

DEPRECIATION AND AMORTIZATION EXPENSES declined 16% from \$249,000 for the fiscal 2000 quarter to \$208,000 for the fiscal 2001 quarter, due to some long-lived assets becoming fully depreciated during the fiscal 2001 quarter.

INTEREST EXPENSE declined 14%, from \$304,000 for the fiscal 2000 quarter to \$260,000 for the fiscal 2001 quarter due debt refinanced with lower, fixed interest rates during fiscal 2000 and fiscal 2001.

INVENTORIES increased 13%, from \$5.5 million at June 30, 2000 to \$6.1 million at June 30, 2001. The increase was primarily related to earlier receipt of most Christmas merchandise in fiscal 2001 than in the comparable period in fiscal 2000. Total purchases of Christmas merchandise for the year are expected to increase modestly compared to purchases of Christmas merchandise for 2000.

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NINE-MONTH PERIOD ENDED JUNE 30, 2001 COMPARED WITH NINE-MONTH PERIOD ENDED JUNE 30, 2000

NINE MONTH HIGHLIGHTS (UNAUDITED)	Fiscal 2001	Fiscal 2000
-----	-----	-----
Consolidated net sales	\$37.6	\$38.3
Retail segment sales	37.5	38.2
Growing segment sales	2.3	2.6
Less: internal sales	\$(2.2)	\$(2.5)
Sales increase (decrease)	(2%)	77%
Same-store sales increase (decrease)	(2%)	4%
Gross profit margin	51%	51%
Income from continuing operations before income taxes	\$ 4.1	\$ 4.5
Income from continuing operations per share (basic)	\$.38	\$.47
Cash flows from operations	\$ 2.3	\$ 4.7

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CONSOLIDATED NET SALES declined by 2%. Same-store sales (sixteen Calloway's stores in Dallas-Fort Worth and three Cornelius stores in Houston) also declined 2%. The decline in Retail sales was primarily attributable to reduced consumer demand in the Company's market areas during the fall (October - November 2000) and winter (January - March 2001) periods, partially offset by stronger consumer demand during the spring (April - June 2001) period.

GROSS MARGIN was 51% for both the fiscal 2001 and fiscal 2000 nine-month periods.

OPERATING EXPENSES declined 2%, from \$10.4 million for the fiscal 2000 nine-month period to approximately \$10.1 million for the fiscal 2001 nine-month period. The decline was primarily due to lower bonus expenses. Bonuses are tied to improvements in profitability and related measures. The fiscal 2000 period had significant improvement in most of those measures for most units, while results for the fiscal 2001 period did not improve for most units.

ADVERTISING EXPENSES increased 7% from approximately \$1.2 million for the fiscal 2000 nine-month period to approximately \$1.3 million for the fiscal 2001 nine-month period. The increase was primarily due to additional expenses incurred during spring 2001 to stimulate consumer demand for the Company's Retail stores.

OCCUPANCY EXPENSES declined 8% from approximately \$2.1 million for the fiscal 2000 nine-month period to approximately \$1.9 million for the fiscal 2001 nine-month period. The reduction was primarily due to lower estimated property taxes for fiscal 2001 than had been expected for the comparable period in fiscal 2000.

INTEREST EXPENSE rose 14%, from \$770,000 to \$878,000, primarily as a result of increased seasonal borrowings under the Company's revolving line of credit. The increased borrowings were necessary because of the reduced Sales for the first six months of fiscal 2001 compared to the first six-months of fiscal 2000. All of those seasonal borrowings were repaid during April 2001.

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DISCONTINUED OPERATIONS

QUARTER ENDED JUNE 30, 2001 COMPARED WITH QUARTER ENDED JUNE 30, 2000

SALES decreased 21%. The decrease in sales was primarily attributed to continued pressure from lower cost wholesalers.

GROSS PROFIT declined from 50% for the fiscal 2000 quarter to (14%) for the fiscal 2001 period. The decline was caused by the substantial decline in sales for the quarter and nine-month period, which caused excessive quantities of inventory, resulting in a \$1.1 million markdown to lower of cost or market at June 30, 2001.

OPERATING EXPENSES declined 4%. The decline was a result of reduced expenses needed to support the reduced volume of sales.

OCCUPANCY EXPENSES increased 14%. The increase was a result of an increase in property tax expenses.

DEPRECIATION AND AMORTIZATION increased 150%. The increase was a result of the addition of fixtures and equipment during fiscal 2001.

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INVENTORY declined 76%. The decrease in inventory was due to the \$1.1 million markdown referred to above, as well as the expected losses on disposal through discontinued operations of the Turkey Creek Farms inventory.

NINE MONTH PERIOD ENDED JUNE 30, 2001 COMPARED WITH NINE MONTH PERIOD ENDED JUNE 30, 2000

SALES declined 33%. The decrease in sales was primarily attributed to continued pressure from lower cost wholesalers.

GROSS PROFIT declined from 32% for the fiscal 2000 quarter to 13% for the fiscal 2001 period. The decline was caused by the substantial decline in sales for the quarter and nine-month period, which caused excessive quantities of inventory, resulting in a \$1.1 million markdown to lower of cost or market at June 30, 2001.

OPERATING EXPENSES declined 33%. The decline was a result of reduced expenses needed to support the reduced volume of sales.

OCCUPANCY EXPENSES increased 11%. The increase was a result of an increase in property tax expenses.

DEPRECIATION AND AMORTIZATION increased 48%. The increase was a result of the addition of fixtures and equipment during fiscal 2001.

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CAPITAL RESOURCES AND LIQUIDITY

CASH FLOWS FROM OPERATING ACTIVITIES

The Company had Cash Provided by Operating Activities of approximately \$2.3 million for the fiscal 2001 nine-month period compared to Cash Provided by Operating Activities of approximately \$4.7 million for the fiscal 2000 nine-month period.

The primary causes of the difference were: (i) approximately \$1.4 million in estimated Federal Income Tax payments, that were accrued in fiscal 2000, were paid during fiscal 2001, and (ii) income from continuing operations declined from \$2.8 million for the fiscal 2000 nine-month period to \$2.5 million for the fiscal 2001 nine-month period.

CASH FLOWS FROM INVESTING ACTIVITIES

The Company had approximately \$423,000 in Cash Used for Investing Activities for the fiscal 2001 nine-month period compared to approximately \$1.7 million in Cash Used for Investing Activities for the fiscal 2000 nine-month period. Most of the \$1.7 million in capital expenditures for the fiscal 2000 nine-month period was for a new store that the Company built and opened in April 2000. There was no new store construction during the fiscal 2001 nine-month period.

CASH FLOWS FROM FINANCING ACTIVITIES

The Company had approximately \$364,000 in Cash Provided by Financing Activities for the fiscal 2001 nine-month period compared to Cash Provided by Financing Activities of approximately \$591,000 for the fiscal 2000 nine-month period.

During the fiscal 2001 nine-month period the Company entered into three notes payable totaling approximately \$4.9 million.

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- (i) One of the three notes was for approximately \$2.6 million, and it refinanced approximately \$2.5 million of a separate real estate note payable, reducing the balance from approximately \$4.5 million to approximately \$2.0 million, extending the maturity date, and providing a fixed interest rate instead of a variable interest rate.
- (ii) The second note payable was for approximately \$1.1 million, and it refinanced approximately \$1.0 million of the same real estate note payable described in (i) above, further reducing the balance from approximately \$2.0 million to approximately \$1.0 million, extending the maturity date, and providing a fixed interest rate instead of a variable interest rate. (See Note 6 to Financial Statements)
- (iii) The third note payable was for approximately \$1.2 million, and it replaced a construction loan of approximately \$0.8 million, extending the maturity date and providing a fixed interest rate instead of a variable interest rate.

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We anticipate that cash flows from operations and our \$5,000,000 revolving line of credit arrangement will be sufficient to meet our working capital needs. On August 7, 2001 the Company adopted a formal plan to dispose of the wholesale operations, which had been a part of its Wholesale and Growing segment (see Note 7 to Financial Statements). The discontinuance of the wholesale operations has not caused the Company to be in violation of its various bank covenants. However, the Company could require a waiver of the debt coverage ratio (a ratio comparing net income plus depreciation and amortization to current portion of long-term debt) at some time during fiscal 2002. In the event this occurs, the Company will seek a waiver from its bank lender.

DISCONTINUED OPERATIONS

On August 7, 2001 the Company adopted a formal plan to dispose of the wholesale operations, which had been a part of its Wholesale and Growing segment. The Company plans to exit its wholesale operations by the end of November 2001. Specifically, the Company will cease in an orderly fashion production and marketing of plants and related products grown or purchased for sale to wholesale customers, including other nursery retailers and landscape contractors. The wholesale operation includes the wholesale growing operations of Turkey Creek Farms as well as the wholesale landscape distribution centers ("WLD") in Austin and Houston. At Turkey Creek Farms, the Company will exclusively grow plants for sale at its retail stores. The adopted disposal plan includes: (i) the sale of the Turkey Creek Farms wholesale inventories to unaffiliated customers, and (ii) the active marketing for sale of the WLD operations.

The Company has incurred operating losses and negative cash flows in the wholesale operations for most of the last two fiscal years. The continued pressure from lower cost wholesalers has impacted the profitability and competitive position of these operations. The Company has concluded that market conditions today and for the foreseeable future are such that these operations are likely to remain uncompetitive. Additionally, incremental future investments would not generate sufficient income to recover the cost of such investments.

The Company recorded a loss on disposal of discontinued operations of

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approximately \$3.0 million (net of income taxes) in the quarter ended June 30, 2001 to cover the expected cash and non-cash costs of the discontinued operations. The loss includes the write down to estimated net realizable value of the investment in facilities and equipment, inventory, and accounts receivable, as well as the accrual of anticipated operating losses during the period after the date the disposal plan was adopted, through the date the disposition is completed.

Prior to this decision, the Company grew plants for sale to external customers in addition to plants grown for sale in its retail stores. The Company intends to grow a greater amount of plants that are solely for sale in its retail stores.

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Following is a summary of the asset and liabilities of the discontinued wholesale operations as of the applicable periods (amounts in thousands):

	June 30, 2001 -----	September 30, 2000 -----	June 30, 2000 -----
ASSETS			
Accounts receivable	\$ 887	\$ 818	\$1,167
Inventories	1,434	6,089	5,813
	-----	-----	-----
Current assets of discontinued operations	\$2,321	\$6,907	\$6,980
	=====	=====	=====
Property and equipment, net	\$ 629	\$ 637	\$ 640
	-----	-----	-----
Noncurrent assets of discontinued operations	\$ 629	\$ 637	\$ 640
	=====	=====	=====
LIABILITIES			
Accounts payable	\$ 615	\$ 799	\$ 491
Accrued expenses	957	250	92
	-----	-----	-----
Current liabilities of discontinued operations	\$1,572	\$1,049	\$ 583
	=====	=====	=====

As discussed in Note 6, long-term debt (including current portion) of \$1,100,000 that is collateralized by the WLD real property is included in the condensed consolidated balance sheet as of June 30, 2001. That note payable was entered into in April 2001 with the proceeds being used to reduce the amount outstanding on a note payable to another financial institution. Prior to April 2001 there was no separate indebtedness related only to the WLD real property. A portion of the proceeds from the sale of the WLD real property will be used to pay off the \$1,100,000 note payable referred to above.

Following is a summary of the operating results of the discontinued wholesale operations for the applicable periods (amounts in thousands):

Nine	Nine	Three	Three
------	------	-------	-------

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	month period ended June 30, 2001 -----	month period ended June 30, 2000 -----	month period ended June 30, 2001 -----	month period ended June 30, 2000 -----
Sales	\$ 5,287	\$ 7,886	\$ 2,339	\$ 2,953
Cost of goods sold	4,591	5,395	2,657	1,464
	-----	-----	-----	-----
Gross profit	696	2,491	(318)	1,489
Operating expenses	1,400	2,092	529	550
Occupancy expenses	266	240	84	74
Advertising expenses	6	8	2	4
Depreciation and amortization	40	27	20	8
Interest expense	2	--	--	--
	-----	-----	-----	-----
Total expenses	1,714	2,367	635	636
	-----	-----	-----	-----
Income (loss) from discontinued operations before income taxes	(1,018)	124	(953)	853
Income taxes (benefit)	(371)	45	(346)	310
	-----	-----	-----	-----
Income (loss) from discontinued operations	(\$ 647)	\$ 79	(\$ 607)	\$ 543
	=====	=====	=====	=====

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The Company recorded a loss on disposal of discontinued operations (net of income tax) of \$3,027,000 for the nine-month and three-month periods ended June 30, 2001. The loss included the expected loss on the disposal of the Turkey Creek Farms wholesale inventory, partially offset by expected gains on the sale of other assets, and estimated income tax benefits of \$1,736,000.

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001 the FASB issued Statement No. 141, Business Combinations and Statement No. 142, Goodwill and Other Intangible Assets. Statement 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001 as well as all purchase method business combinations completed after June 30, 2001. Statement 141 also specifies criteria intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill, noting that any purchase price allocable to an assembled workforce may not be accounted for separately. Statement 142 will require that goodwill and intangible assets with indefinite lives no longer be amortized, but instead tested for impairment at least annually in accordance with the provisions of Statement 142. Statement 142 will also require that intangible assets with indefinite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of.

The Company is required to adopt the provisions of Statement 141 immediately. Statement 142 is effective January 1, 2002. Companies with fiscal years beginning after March 15, 2001 who have not yet issued financial statements for their first interim period may early adopt Statement 142. The Company is in the

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process of determining whether or not it will early adopt Statement 142. Goodwill and intangible assets acquired in business combinations completed before July 1, 2001 will continue to be amortized prior to the adoption of Statement 142.

Upon adoption of Statement 142 the Company will be required to reassess the useful lives and residual values of all intangible assets acquired in purchase business combinations, and make any necessary amortization period adjustments by the end of the first interim period after adoption. In addition, to the extent an intangible asset is identified as having an indefinite useful life, the Company will be required to test the intangible asset for impairment in accordance with the provisions of Statement 142 within the first interim period.

Any impairment loss will be measured as of the date of adoption and recognized as the cumulative effect of a change in accounting principle in the first interim period.

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As of October 1, 2001 the Company expects to have unamortized goodwill in the amount of \$740,000 that will be subject to the transition provisions of Statements 141 and 142. Amortization expense related to goodwill was \$108,000 for the fiscal year ended September 30, 2000 and \$81,000 for the nine-month period ended June 30, 2001. Because of the extensive effort that will be needed to comply with adopting Statements 141 and 142, it is not practicable to reasonably estimate the impact of adopting these Statements on the Company's consolidated financial statements at the date of this report, including whether any transitional impairment losses will be required to be recognized as the cumulative effect of a change in accounting principle.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Calloway's is exposed to certain market risks, including fluctuations in interest rates. We do not enter into transactions designed to mitigate such market risks for trading or speculative purposes. As of June 30, 2001, we had no foreign exchange contracts and/or options outstanding.

We manage our interest rate risk by arranging for most long-term debt to be at fixed rates, and for debt with shorter maturities, (including our revolving line of credit) to have variable interest rates. For our variable-rate debt, interest rate changes generally do not affect the fair market value of such debt, but do impact future earnings and cash flows, assuming other factors are held constant.

At June 30, 2001 Calloway's had variable rate debt of approximately \$2.0 million, out of total debt of \$10.6 million. Holding other variables, such as debt levels, constant, a one percentage point increase in interest rates would be expected to have an estimated annual impact on income before income taxes and cash flows of approximately \$20,000.

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PART 2. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

None.

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ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None.

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits:

None.

(b) Reports on Form 8-K:

None.

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SIGNATURES

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

Dated: August 14, 2001

CALLOWAY'S NURSERY, INC.

By /s/ James C. Estill

James C. Estill, President and
Chief Executive Officer

By /s/ Daniel G. Reynolds

Daniel G. Reynolds, Vice President
and Chief Financial Officer

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