CHAMPION ENTERPRISES INC
Form 10-Q
August 01, 2006

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FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

(Mark one)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

For Quarterly period ended July 1, 2006

OR

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

For the transition period from to

Commission file number 1-9751
CHAMPION ENTERPRISES, INC.

(Exact name of registrant as specified in its charter)

Michigan	38-2743168
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2701 Cambridge Court, Suite 300
Auburn Hills, MI 48326

(Address of principal executive offices)

Registrant s telephone number, including area code: (248) 340-9090

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

Yes x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2 of the Act).

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

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

76,455,995 shares of the registrant s $1.00 par value Common Stock were outstanding as of July 31, 2006.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements.
CHAMPION ENTERPRISES, INC.
Consolidated Statements of Operations
(In thousands, except per share amounts)

	Unaudited Three Months Ended		Unaudited Six Months Ended	
	July 1, 2006	July 2, 2005	July 1, 2006	July 2, 2005
Net sales	$ 370,717	$ 317,100	$ 717,246	$ 561,375
Cost of sales	313,878	261,527	606,114	468,538
Gross margin	56,839	55,573	111,132	92,837
Selling, general and administrative expenses	41,326	36,655	78,649	68,402
Mark-to-market credit for common stock warrant		(500)		(4,300)
Loss on debt retirement		901		901
Operating income	15,513	18,517	32,483	27,834
Interest income	1,189	929	2,730	1,702
Interest expense	(5,200)	(4,628)	(8,811)	(9,209)
Income from continuing operations before income taxes	11,502	14,818	26,402	20,327
Income tax (benefit) expense	(108,303)	600	(107,103)	900
Income from continuing operations	119,805	14,218	133,505	19,427
Income (loss) from discontinued operations, net of taxes	77	(751)	24	(3,309)
Net income	$ 119,882	$ 13,467	$ 133,529	$ 16,118
Basic income (loss) per share:				
Income from continuing operations	$ 1.57	$ 0.19	$ 1.75	$ 0.25
Income (loss) from discontinued operations		(0.01)		(0.05)
Basic income per share	$ 1.57	$ 0.18	$ 1.75	$ 0.20

Weighted shares for basic EPS	76,343	75,176	76,212	73,861
Diluted earnings (loss) per share:				
Income from continuing operations	$ 1.55	$ 0.18	$ 1.72	$ 0.25
Income (loss) from discontinued operations		(0.01)		(0.05)
Diluted income per share	$ 1.55	$ 0.17	$ 1.72	$ 0.20
Weighted shares for diluted EPS	77,495	76,042	77,438	74,756

See accompanying Notes to Consolidated Financial Statements.

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CHAMPION ENTERPRISES, INC.
Consolidated Balance Sheets
(In thousands, except par value)

	Unaudited July 1, 2006	December 31, 2005
ASSETS		
Current assets		
Cash and cash equivalents	$ 121,646	$ 126,979
Restricted cash	331	713
Accounts receivable, trade	64,263	49,146
Inventories	107,143	108,650
Deferred tax assets	37,559	441
Other current assets	9,450	12,227
Total current assets	340,392	298,156
Property, plant and equipment	235,749	215,146
Less accumulated depreciation	125,914	123,973
	109,835	91,173
Goodwill and other intangible assets	297,871	158,101
Non-current deferred tax assets	97,200	
Other non-current assets	18,602	19,224
	$ 863,900	$ 566,654
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 68,102	$ 29,115
Accrued warranty obligations	33,988	33,509
Accrued volume rebates	30,392	33,056
Accrued compensation and payroll taxes	19,918	26,757
Accrued self-insurance	33,217	30,968
Other current liabilities	44,417	32,686
Total current liabilities	230,034	186,091
Long-term liabilities		
Long-term debt	282,896	201,727
Long-term deferred tax liabilities	23,375	124
Other long-term liabilities	39,337	31,407
	345,608	233,258
Contingent liabilities (Note 8)		

Shareholders equity		
Common stock, $1 par value, 120,000 shares authorized, 76,456 and 76,045 shares issued and outstanding, respectively	76,456	76,045
Capital in excess of par value	197,417	192,905
Retained earnings (accumulated deficit)	11,666	(121,863)
Accumulated other comprehensive income	2,719	218
Total shareholders equity	288,258	147,305
	$ 863,900	$ 566,654

See accompanying Notes to Consolidated Financial Statements.

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CHAMPION ENTERPRISES, INC.
Consolidated Statements of Cash Flows
(In thousands)

	Unaudited Six Months Ended	
	July 1, 2006	July 2, 2005*
Cash flows from operating activities		
Net income	$ 133,529	$ 16,118
(Income) loss from discontinued operations	(24)	3,309
Adjustments to reconcile net income to net cash provided by continuing operating activities:		
Depreciation and amortization	8,064	5,063
Stock-based compensation	3,348	2,590
Change in deferred taxes	(109,700)	
Mark-to-market credit for common stock warrant		(4,300)
Loss on debt retirement		901
Gain on disposal of fixed assets	(4,528)	(1,599)
Increase/decrease		
Accounts receivable	11,199	(19,575)
Inventories	5,952	(9,269)
Accounts payable	(266)	19,701
Accrued liabilities	(10,394)	(2,222)
Other, net	2,014	2,642
Net cash provided by continuing operating activities	39,194	13,359
Cash flows from investing activities		
Additions to property, plant and equipment	(9,058)	(5,290)
Acquisition of Calsafe Group (Holdings) Limited, net	(100,364)	
Acquisition of Highland Manufacturing Company, LLC	(22,828)	
Investments in and advances to unconsolidated subsidiaries		(55)
Proceeds on disposal of fixed assets	5,763	5,056
Net cash used for investing activities	(126,487)	(289)
Cash flows from financing activities		
Payments on long-term debt	(829)	(128)
Proceeds from Term Loan	78,561	
Purchase of Senior Notes		(9,885)
Increase in deferred financing costs	(995)	
Decrease in restricted cash	382	1
Purchase of common stock warrant		(4,500)
Common stock issued, net	1,955	597
Dividends paid on preferred stock		(293)

Net cash provided by (used for) financing activities	79,074	(14,208)
Cash flows from discontinued operations		
Net cash provided by (used for) operating activities of discontinued operations	486	(3,565)
Net cash provided by investing activities of discontinued operations	568	24,232
Net cash used for financing activities of discontinued operations		(11,896)
Net cash provided by discontinued operations	1,054	8,771
Effect of exchange rate changes on cash and cash equivalents	1,832	
Net (decrease) increase in cash and cash equivalents	(5,333)	7,633
Cash and cash equivalents at beginning of period	126,979	142,266
Cash and cash equivalents at end of period	$ 121,646	$ 149,899

* The 2005 Statement of Cash Flows has been revised to separately disclose the operating, investing, and financing portions of the cash flows attributable to discontinued operations. These amounts were previously reported on a combined basis.

See accompanying Notes to Consolidated Financial Statements.

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CHAMPION ENTERPRISES, INC.
Consolidated Statement of Shareholders Equity
Unaudited Six Months Ended July 1, 2006
(In thousands)

	Common stock Shares	Common stock Amount	Capital in excess of par value	Retained earnings (accumulated deficit)	Accumulated other comprehensive income	Total
Balance at December 31, 2005	76,045	$ 76,045	$ 192,905	$ (121,863)	$ 218	$ 147,305
Net income				133,529		133,529
Stock options and benefit plans	411	411	4,512			4,923
Foreign currency translation adjustments					2,501	2,501
Balance at July 1, 2006	76,456	$ 76,456	$ 197,417	$ 11,666	$ 2,719	$ 288,258

See accompanying Notes to Consolidated Financial Statements.

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CHAMPION ENTERPRISES, INC.
Notes to Consolidated Financial Statements
(Unaudited)

1. The Consolidated Financial Statements are unaudited, but in the opinion of management include all adjustments necessary for a fair statement of the results of the interim periods. All such adjustments are of a normal recurring nature except for the reversal of 100% of the valuation allowance for deferred tax assets (see Note 3). Financial results of the interim periods are not necessarily indicative of results that may be expected for any other interim period or for the fiscal year. The balance sheet as of December 31, 2005 was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States.

For a description of significant accounting policies used by Champion Enterprises, Inc. (Champion or the Company) in the preparation of its consolidated financial statements, please refer to Note 1 of Notes to Consolidated Financial Statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. The Company acquired United Kingdom-based Calsafe Group (Holdings) Limited (Calsafe) on April 7, 2006 (see Note 2). Calsafe uses the percentage of completion method of revenue recognition for its modular building contracts using the cost-to-cost basis.

The Company operates in three segments. The North American manufacturing segment (the manufacturing segment) consists of 32 manufacturing facilities as of July 1, 2006 that primarily factory-build manufactured and modular houses throughout the U.S. and in western Canada. The international manufacturing segment (the international segment) consists of Calsafe and its operating subsidiary Caledonian Building Systems Limited (Caledonian), which were acquired in April 2006. Caledonian currently operates three manufacturing facilities in the United Kingdom. The retail segment sells manufactured houses to consumers throughout California.

During 2005, the Company completed the disposal of its traditional retail operations through the sale of its remaining 42 traditional retail sales centers. As a result, the Company s traditional retail operations, excluding its non-traditional California operations, are classified as discontinued operations for the periods reported. Also included in discontinued operations is the Company s former consumer finance business that was exited in 2003. Continuing retail operations in 2006 and 2005 consist of ongoing non-traditional California retail operations.

The Company has various stock option and stock-based incentive plans and agreements whereby stock options, performance share awards, restricted stock awards, and other stock-based incentives are made available to certain employees, directors, and others. The Company accounts for these stock-based employee compensation programs under Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, (SFAS No. 123(R)). Awards of performance shares and restricted stock are accounted for by valuing unvested shares expected to be earned at grant date market value. The fair value of stock options has been determined by using the Black-Scholes option-pricing model. Stock-based compensation cost was $1.5 million and $3.3 million for the three and six months ended July 1, 2006, respectively, and $1.6 million and $2.6 million for the three and six months ended July 2, 2005, respectively, and is included in selling, general, and administrative expenses.

SFAS No. 123(R) provides that any corporate income tax benefit realized upon exercise or vesting of an award in excess of that previously recognized in earnings (referred to as a windfall tax benefit) will be presented in the consolidated statement of cash flows as a financing (rather than an operating) cash flow. Realized windfall tax benefits are credited to capital in excess of par in the consolidated balance sheet. Realized shortfall tax benefits (amounts which are less than that previously recognized in earnings) are first offset against the cumulative balance of windfall tax benefits, if any, and then charged directly to income tax expense. Under the transition rules for adopting SFAS No. 123(R) using the modified prospective method, the Company was permitted to calculate a cumulative memo balance of windfall tax benefits from post-1995 years for the purpose of accounting for future shortfall tax benefits. The Company completed such study during the quarter ended December 31, 2005, the period of adoption, and currently has sufficient cumulative memo windfall tax benefits to absorb arising shortfalls, such that earnings were not affected in the periods presented. Because the Company has net operating loss carryforwards for tax purposes (see Note 3), there are no windfall tax benefit cash flows realized in the periods presented.

Recent accounting pronouncement

In June 2006, the Financial Accounting Standards Board issued Interpretation Number 48 (FIN 48) *Accounting for*

Uncertainty in Income Taxes an interpretation of FASB Statement No. 109. FIN 48 is effective beginning with the Company s 2007 fiscal year. FIN 48 clarifies accounting for uncertain tax positions utilizing a more likely than not recognition threshold for a tax position. The Company shall initially recognize the financial statement effects of a tax position when it is more likely than not, based on the technical merits of the tax position, that such a position will be sustained upon examination by the relevant tax authorities. If the tax benefit meets the more likely than not threshold, the measurement of the tax benefit would be based on the best estimate of the ultimate tax benefit that

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will be sustained upon audit by the taxing authority. The Company has not yet determined the impact, if any, of this new accounting standard on its consolidated statement of operations and financial position.

2. On April 7, 2006, the Company acquired United Kingdom-based Calsafe Group (Holdings) Limited and its operating subsidiary Caledonian Building Systems Limited (Caledonian), (collectively, the Calsafe group), for approximately $100 million in cash, plus potential contingent purchase price of up to approximately $6.4 million and additional potential contingent consideration to be paid over four years. The final purchase price will ultimately be determined based upon the achievement of certain financial benchmarks over the three years and three quarters ending December 2009. The transaction was financed through a combination of debt, via an approximately $80 million Sterling-denominated increase in Champion s credit facility, and cash.

Caledonian, a leading modular manufacturer, constructs steel-framed modular buildings for use as prisons, residences and hotels, as well as military accommodations for the UK Ministry of Defence. Caledonian s steel-framed modular technology allows for multi-story construction, a key advantage over North American wood-framed construction techniques.

The results of operations of the Calsafe group from the acquisition date to July 1, 2006 are included in the Company s results from continuing operations and in its international segment for the three and six months ended July 1, 2006. The purchase price allocation related to this acquisition has not yet been finalized pending completion of certain asset valuations. An unaudited condensed balance sheet of the acquired business at April 7, 2006 based on an initial purchase price allocation is as follows:

	April 7, 2006 (In thousands)
Current assets	$ 36,600
Property, plant and equipment	12,600
Goodwill	117,200
Other non-current assets	100
Total assets	166,500
Current liabilities	47,400
Long-term liabilities	1,600
Net assets of acquired business	$ 117,500

On March 31, 2006, the Company acquired 100% of the membership interests of Highland Manufacturing Company, LLC (Highland), a manufacturer of modular and HUD-code homes, for cash consideration of $23 million. This acquisition expanded the Company s presence in the modular homebuilding industry and increased its manufacturing and distribution in several states under-served by Champion in the north central United States.

The results of operations of Highland from the acquisition date to July 1, 2006 are included in the Company s results from continuing operations and in its manufacturing segment for the three and six months ended July 1, 2006. Goodwill and other intangible assets recognized in the transaction amounted to approximately $17.6 million, substantially all of which is expected to be fully deductible for tax purposes. All of the goodwill and intangible assets were assigned to the manufacturing segment. Trade names were valued based upon the royalty-saving method and customer relationships were valued based upon the excess earnings method. The estimated fair values assigned to the assets and liabilities from the Highland acquisition include current assets totaling $4.1 million, plant, property and equipment totaling $4.0 million, current liabilities totaling $2.9 million, and the following for amortizable intangible assets and goodwill, and the respective amortization periods and annual amortization expense:

	Amortization	Expected Annual

	Amount (In thousands)	Period (Years)	Amortization (In thousands)
Trade names	$ 2,600	15	$ 173
Customer relationships	4,200	15	280
Other amortizable intangible assets	520	7	74
Goodwill	10,291		
Total goodwill and intangible assets	$ 17,611		$ 527

On August 8, 2005, pursuant to three separate asset purchase agreements, the Company acquired the assets and business of New Era Building Systems, Inc. and its affiliates, Castle Housing of Pennsylvania, Ltd. and Carolina Building Solutions, LLC (collectively, the New Era group), modular homebuilders, for aggregate cash consideration of $41.4 million plus the assumption of certain current liabilities.

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The following table presents unaudited pro forma combined results as if Champion had acquired the New Era group, Highland and the Calsafe group at the beginning of the periods presented, instead of August 8, 2005, March 31, 2006, and April 7, 2006, respectively:

	Unaudited Three Months Ended	Unaudited Six Months Ended	
	July 2, 2005	July 1, 2006	July 2, 2005
	(In thousands, except per share)		
Net sales	$ 398,255	$ 764,861	$ 710,716
Net income	14,945	136,062	19,970
Diluted income per share	$ 0.19	$ 1.76	$ 0.25

The pro forma results include amortization of amortizable intangible assets acquired and valued in the transactions. The pro forma results are not necessarily indicative of what actually would have occurred if the transactions had been completed as of the beginning of each of the fiscal periods presented, nor are they necessarily indicative of future consolidated results.

3. The provisions for income tax differ from the amount of income tax determined by applying the applicable statutory federal income tax rates to pretax income from continuing operations and pretax income (loss) from discontinued operations as a result of the following differences:

	Six Months Ended	
	July 1, 2006	July 2, 2005
	(In thousands)	
Continuing operations		
Tax at federal statutory tax rates	$ 9,200	$ 7,100
(Decrease) increase in rate resulting from:		
Warrant mark-to-market and other permanent differences	(500)	(1,300)
Adjustment of deferred tax valuation allowance	(116,000)	(5,000)
Foreign and state taxes	197	100
Total income tax (benefit) expense	$ (107,103)	$ 900

	Six Months Ended	
	July 1, 2006	July 2, 2005
	(In thousands)	
Discontinued operations		
Tax at federal statutory tax rates	$	$ (1,200)
Increase in rate resulting from:		
Adjustment of deferred tax valuation allowance		1,200
Total income tax	$	$

On July 1, 2006, the Company reversed 100% of its valuation allowance for deferred tax assets totaling $109.7 million after making the determination that realization of the deferred tax assets was more likely than not. The $109.7 million reversal includes the tax effect of the change in net operating losses for the six months ended July 1, 2006. As of December 31, 2005, the Company had available federal net operating loss carryforwards of approximately $130 million for tax purposes to offset certain future federal taxable income. These loss carryforwards expire in 2023 through 2025. Additionally, as a result of the sale of its remaining traditional retail operations during 2005, approximately $49 million of additional net operating losses will become available during 2006, upon completion of certain disposal activities.

As of December 31, 2005, the Company had available state net operating loss carryforwards of approximately $156 million for tax purposes to offset future state taxable income. These carryforwards expire in 2016 through 2025.

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4. A summary of inventories by component follows:

	July 1, 2006	December 31, 2005
	(In thousands)	
New manufactured homes	$ 33,774	$ 36,843
Raw materials	40,677	41,525
Work-in-process	10,790	10,621
Other inventory	21,902	19,661
	$ 107,143	$ 108,650

Other inventory consists of park spaces and improvements, net of inventory reserves.

5. The Company s manufacturing segment generally provides the retail homebuyer or the builder/developer with a twelve-month warranty from the date of purchase. Estimated warranty costs are accrued as cost of sales primarily at the time of the manufacturing sale. Warranty provisions and reserves are based on estimates of the amounts necessary to settle existing and future claims for homes sold by the manufacturing operations as of the balance sheet date. The following table summarizes the changes in accrued product warranty obligations during the six months ended July 1, 2006 and July 2, 2005. A portion of warranty reserves was classified as other long-term liabilities in the consolidated balance sheet.

	Six Months Ended	
	July 1, 2006	July 2, 2005
	(In thousands)	
Reserves at beginning of year	$ 40,009	$ 40,051
Warranty expense provided	26,606	24,365
Warranty reserves from acquisitions	483	
Cash warranty payments	(26,610)	