CARTERS INC
Form 10-Q
November 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

001-31829

CARTER S, INC.

(Exact name of Registrant as specified in its charter)

Delaware	**13-3912933**
(State or other jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

The Proscenium

1170 Peachtree Street NE, Suite 900

Atlanta, Georgia 30309

(Address of principal executive offices, including zip code)

(404) 745-2700

(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 x No o

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

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.

Common Stock	**Outstanding Shares at November 9, 2006**
Common stock, par value $0.01 per share	58,868,080

CARTER S, INC.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

CARTER S, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except for share data)

(unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 29,956	$ 84,276
Accounts receivable, net	150,835	96,144
Inventories, net	199,849	188,454
Prepaid expenses and other current assets	9,696	6,262
Deferred income taxes	19,739	23,909
Total current assets	410,075	399,045
Property, plant, and equipment, net	79,863	79,458
Tradenames	322,233	322,233
Cost in excess of fair value of net assets acquired	279,756	284,172
Deferred debt issuance costs, net	6,797	8,257
Licensing agreements, net	13,959	17,150
Leasehold interests, net	1,268	1,619
Other assets	5,144	4,793
Total assets	$ 1,119,095	$ 1,116,727
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current maturities of long-term debt	$ 2,984	$ 3,241
Accounts payable	44,395	63,735
Other current liabilities	79,151	89,627
Total current liabilities	126,530	156,603
Long-term debt	389,915	426,791
Deferred income taxes	126,145	124,439
Other long-term liabilities	22,111	22,250
Total liabilities	664,701	730,083
Commitments and contingencies		
Stockholders equity:		
Preferred stock; par value $.01 per share; 100,000 shares authorized; none issued or outstanding at September 30, 2006 and December 31, 2005		
Common stock, voting; par value $.01 per share; 150,000,000 shares authorized; 58,179,118 shares issued and outstanding at September 30, 2006; 40,000,000 shares authorized, 28,909,729 shares issued and outstanding at December 31, 2005	582	289
Additional paid-in capital	265,345	260,414
Deferred compensation		(2,749)
Accumulated other comprehensive income	1,350	1,354
Retained earnings	187,117	127,336
Total stockholders equity	454,394	386,644
Total liabilities and stockholders equity	$ 1,119,095	$ 1,116,727

See accompanying notes to the unaudited condensed consolidated financial statements

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CARTER S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(dollars in thousands, except for share data)

(unaudited)

	For the three-month periods ended September 30, 2006	For the three-month periods ended October 1, 2005	For the nine-month periods ended September 30, 2006	For the nine-month periods ended October 1, 2005
Net sales	$ 391,977	$ 372,158	$ 966,001	$ 770,865
Cost of goods sold	244,757	243,497	613,382	500,374
Gross profit	147,220	128,661	352,619	270,491
Selling, general, and administrative expenses	93,496	89,303	258,944	192,542
Closure costs		1,509	91	6,078
Royalty income	(7,782)	(7,208)	(21,610)	(13,544)
Operating income	61,506	45,057	115,194	85,415
Loss on extinguishment of debt		20,137		20,137
Interest expense, net	6,554	7,444	20,367	15,902
Income before income taxes	54,952	17,476	94,827	49,376
Provision for income taxes	19,975	6,898	35,046	19,499
Net income	$ 34,977	$ 10,578	$ 59,781	$ 29,877
Basic net income per common share	$ 0.60	$ 0.18	$ 1.03	$ 0.52
Diluted net income per common share	$ 0.57	$ 0.17	$ 0.98	$ 0.49
Basic weighted-average number of shares outstanding	57,949,783	57,439,850	57,845,521	57,177,740
Diluted weighted-average number of shares outstanding	61,094,141	60,932,056	61,173,247	60,672,620

See accompanying notes to the unaudited condensed consolidated financial statements

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CARTER S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in thousands)

(unaudited)

	For the nine-month periods ended September 30, 2006		October 1, 2005	
Cash flows from operating activities:				
Net income	$ 59,781		$ 29,877	
Adjustments to reconcile net income to net cash (used in) provided by operating activities:				
Depreciation and amortization	18,272		16,207	
Loss on extinguishment of debt			20,137	
Amortization of inventory step-up			10,370	
Amortization of debt issuance costs	1,460		1,892	
Accretion of debt discount			40	
Income tax benefit from exercised stock options	(2,472	)	5,184	
Non-cash stock-based compensation expense	4,349		1,108	
Non-cash closure costs			113	
Loss (gain) on sale of property, plant, and equipment	197		(109	)
Deferred income taxes	5,666		(3,134	)
Effect of changes in operating assets and liabilities:				
Accounts receivable	(54,691	)	(36,289	)
Inventories	(11,395	)	(14,627	)
Prepaid expenses and other assets	(3,090	)	(1,938	)
Accounts payable and other liabilities	(23,310	)	5,328	
Net cash (used in) provided by operating activities	(5,233	)	34,159	
Cash flows from investing activities:				
Acquisition of OshKosh B Gosh, Inc., net of cash acquired			(309,910	)
Capital expenditures	(15,861	)	(10,650	)
Proceeds from sale of property, plant, and equipment	348		528	
Sale of investments			60,100	
Purchase of investments			(50,175	)
Collections on loan			2,954	
Net cash used in investing activities	(15,513	)	(307,153	)
Cash flows from financing activities:				
Proceeds from new term loan			500,000	
Payments on new term loan	(37,133	)	(31,250	)
Payments on former term loan			(71,326	)
Borrowings from revolving loan facility	5,000			
Payments on revolving loan facility	(5,000	)		
Repayment of 10.875% Senior Subordinated Notes			(113,750	)
Payment of debt redemption premium			(14,015	)
Payment of debt issuance costs			(10,780	)
Income tax benefit from exercised stock options	2,472		-	
Proceeds from exercise of stock options	1,087		1,593	
Net cash (used in) provided by financing activities	(33,574	)	260,472	

Net decrease in cash and cash equivalents	(54,320)	(12,522)
Cash and cash equivalents, beginning of period	84,276	33,265
Cash and cash equivalents, end of period	$ 29,956	$ 20,743

See accompanying notes to the unaudited condensed consolidated financial statements

CARTER S, INC.

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY

(dollars in thousands, except for share data)

(unaudited)

	Common stock	Additional paid-in capital	Deferred compensation	Accumulated other comprehensive income	Retained earnings	Total stockholders equity
Balance at December 31, 2005	$ 289	$ 260,414	$ (2,749)	$ 1,354	$ 127,336	$ 386,644
Tax benefit from exercise of stock options		2,472				2,472
Exercise of stock options (252,288 shares)	2	1,085				1,087
Stock-based compensation expense		3,874				3,874
Issuance of common stock (17,172 shares)		540				540
Reversal of deferred compensation (see Note 9)		(2,749)	2,749			
Two-for-one common stock split (see Note 8)	291	(291)				
Comprehensive income:						
Net income					59,781	59,781
Unrealized gain on interest rate swap, net of taxes of $242				452		452
Unrealized loss on interest rate collar, net of tax benefit of $32				(456)		(456)
Total comprehensive income				(4)	59,781	59,777
Balance at September 30, 2006	$ 582	$ 265,345		$ 1,350	$ 187,117	$ 454,394

See accompanying notes to the unaudited condensed consolidated financial statements

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CARTER S, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1 THE COMPANY:

Carter s, Inc., and its wholly-owned subsidiaries (collectively, the Company, we, us, its, and our) design, source, and market branded childrenswear under the *Carter s, Child of Mine, Just One Year, OshKosh B Gosh*, and related labels. Our products are sourced through contractual arrangements with manufacturers worldwide. Products are sourced for wholesale distribution to major domestic retailers, including the mass channel, and for our 205 *Carter s* brand and 146 *OshKosh* brand retail stores that market our brand name merchandise and other licensed products manufactured by other companies.

On July 14, 2005, Carter s, Inc., through its wholly-owned subsidiary, The William Carter Company (TWCC), acquired all of the outstanding common stock of OshKosh B Gosh, Inc. for a purchase price of $312.1 million, which included payment for vested stock options (the Acquisition). The accompanying unaudited condensed consolidated financial statements include the operations of OshKosh for the three and nine-month periods ended September 30, 2006. Financial results for the three and nine-month periods ended October 1, 2005 include the operations of OshKosh for the period from July 14, 2005 through October 1, 2005.

NOTE 2 BASIS OF PREPARATION:

The accompanying unaudited condensed consolidated financial statements comprise the consolidated financial statements of Carter s, Inc. and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

In our opinion, the Company s accompanying unaudited condensed consolidated financial statements contain all adjustments necessary for a fair statement of our financial position as of September 30, 2006, the results of our operations for the three and nine-month periods ended September 30, 2006 and October 1, 2005, cash flows for the nine-month periods ended September 30, 2006 and October 1, 2005 and changes in stockholders equity for the nine-month period ended September 30, 2006. Except as otherwise noted, all such adjustments consist only of those of a normal recurring nature. Operating results for the nine-month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending December 30, 2006. Our accompanying condensed consolidated balance sheet as of December 31, 2005 is from our audited consolidated financial statements included in our most recently filed Annual Report on Form 10-K, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Certain information and footnote disclosure normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission and the instructions to Form 10-Q. The accounting policies we follow are set forth in our most recently filed Annual Report on Form 10-K in the notes to our consolidated financial statements for the fiscal year ended December 31, 2005.

Our fiscal year ends on the Saturday in December or January nearest to the last day of December. The accompanying unaudited condensed consolidated financial statements for the third quarter and first nine months of fiscal 2006 reflect our financial position as of September 30, 2006. The third quarter and first nine months of fiscal 2005 ended on October 1, 2005.

Certain prior year amounts have been reclassified for comparative purposes.

NOTE 3 BUSINESS COMBINATION AND REFINANCING:

As noted above, on July 14, 2005, we acquired all of the outstanding common stock of OshKosh. The Acquisition was accounted for under the purchase method of accounting. The purchase price for the Acquisition, including related fees and expenses, was allocated to the fair value of tangible and identifiable intangible assets and liabilities acquired with the remainder allocated to cost in excess of fair value of net assets acquired. As part of financing the Acquisition, the Company refinanced its existing debt (the Refinancing), including its senior credit facility (former senior credit facility) and repurchased $113.8 million of 10.875% Senior Subordinated Notes due 2011 (the Notes). The repurchase of the Notes together with the Refinancing and Acquisition is referred to as the Transaction.

Financing for the Transaction was provided by a new $500 million Term Loan 1 (see Note 6) and a $125 million revolving credit facility (including a sub-limit for letters of credit of $80 million, the Revolver) entered into by TWCC with Bank of America, N.A., as administrative agent, Credit Suisse, and certain other financial institutions (the Senior Credit Facility). The term of the Revolver extends to July 14, 2011 and the term of the Term Loan 1 extends to July 14, 2012.

The proceeds from the Refinancing were used to purchase the outstanding common stock and vested stock options of OshKosh ($312.1 million), pay transaction expenses ($6.2 million), refinance the Company s former senior credit facility ($36.2 million), repurchase the Notes ($113.8 million), pay a redemption premium on the Company s Notes ($14.0 million), along with accrued and unpaid interest ($5.1 million), and pay debt issuance costs ($10.6 million). Other Transaction expenses paid prior and subsequent to the closing of the Transaction totaled $1.4 million, including $0.2 million in debt issuance costs.

As a result of the Refinancing, we expensed $4.5 million in unamortized debt issuance costs related to the former senior credit facility and Notes and expensed $0.5 million related to the debt discount on the Notes. Additionally, we expensed approximately $1.1 million of debt issuance costs associated with the Senior Credit Facility in accordance with Emerging Issues Task Force (EITF) No. 96-19, Debtor s Accounting for a Modification or Exchange of Debt Instruments.

The Senior Credit Facility requires us to hedge at least 25% of our variable rate debt under the Term Loan 1. On September 22, 2005, we entered into a swap agreement to receive floating interest and pay fixed interest. This swap agreement is designated as a cash flow hedge of the variable interest payments on a portion of our variable rate Term Loan 1 debt. The swap agreement matures on July 30, 2010. The unrealized (loss) gain, net of taxes, related to the interest rate swap was ($1.3) million and $0.5 million, respectively, for the three and nine-month periods ended September 30, 2006 and is included within accumulated other comprehensive income on the accompanying unaudited condensed consolidated balance sheet. During the three and nine-month periods ended September 30, 2006, we reclassified approximately $0.5 million and $0.9 million, respectively, related to the swap agreement into earnings.

On May 25, 2006, we entered into an interest rate collar agreement (the collar) with a floor of 4.3% and a ceiling of 5.5%. The collar covers $100 million of our variable rate Term Loan 1 debt and is designated as a cash flow hedge of the variable interest payments on such debt. The collar matures on January 31, 2009. The unrealized loss, net of tax benefit, related to the collar was ($0.6) million and ($0.5) million, respectively, for the three and nine-month periods ended September 30, 2006 and is included within accumulated other comprehensive income on the accompanying unaudited condensed consolidated balance sheet.

A summary of the Acquisition purchase price allocation is as follows:

(dollars in thousands)	
Cash and cash equivalents	$ 9,500
Investments	18,355
Accounts receivable	15,979
Inventory	86,201
Deferred tax assets	13,453
Property, plant, and equipment	26,107
Tradename	102,000
Licensing agreements	19,100
Leasehold interests	1,833
Other assets	5,075
Accounts payable	(19,052)
Severance and relocation (Note 11)	(9,733)
Other exit costs (Note 11)	(2,167)
Lease termination costs (Note 11)	(7,200)
Contract termination costs (Note 11)	(1,533)
Deferred tax liabilities	(41,800)
Accrued and other liabilities	(39,820)
Cost in excess of fair value of net assets acquired	143,186
	$ 319,484

The following unaudited pro forma summary presents information as if the Transaction occurred on the first day of fiscal 2005 and assumes that there were no other changes in our operations. This pro forma information does not necessarily reflect the actual results that would have occurred had the Transaction occurred on that date, nor is it necessarily indicative of the future results of operations of the combined Company.

The unaudited pro forma summary reflects the combined Company for the three and nine-month periods ended October 1, 2005, adjusted to reflect increased interest expense, amortization of the capitalized value of OshKosh licensing agreements and leasehold interests, and incremental depreciation expense.

(dollars in thousands, except share data)	**For the three-month period ended October 1, 2005**	**For the nine-month period ended October 1, 2005**
Pro forma net sales	$ 383,065	$ 944,191
Pro forma net income	$ 9,892	$ 20,909
Pro forma basic earnings per share	$ 0.17	$ 0.37
Pro forma diluted earnings per share	$ 0.16	$ 0.34

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NOTE 4 COST IN EXCESS OF FAIR VALUE OF NET ASSETS ACQUIRED AND OTHER INTANGIBLE ASSETS:

In connection with the Acquisition, the Company recorded the cost in excess of fair value of net assets acquired and other intangible assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations.

As of September 30, 2006, cost in excess of fair value of net assets acquired and other intangible assets resulting from the Acquisition were as follows:

(dollars in thousands)	**Weighted-average useful life**	**Gross amount**	**Accumulated amortization**
Cost in excess of fair value of net assets acquired	Indefinite	$ 143,186	$
OshKosh tradename	Indefinite	$ 102,000	$
OshKosh licensing agreements	4.7 years	$ 19,100	$ 5,141
Leasehold interests	4.1 years	$ 1,833	$ 565

During the three-month period ended September 30, 2006, approximately $0.7 million related to pre-Acquisition tax contingencies were reversed due to the closure of certain tax periods. This reversal resulted in a corresponding adjustment to cost in excess of fair value of net assets acquired of $0.7 million in accordance with EITF 93-7, Uncertainties Related to Income Taxes in a Purchase Business Combination (EITF 93-7).

Amortization expense for intangible assets subject to amortization was approximately $1.2 million and $3.5 million for the three and nine-month periods ended September 30, 2006. Annual amortization expenses for the OshKosh licensing agreements and leasehold interests are expected to be as follows:

(dollars in thousands) **Fiscal Year**	**Estimated amortization expense**
2006 (period from October 1 through December 30)	$ 1,180
2007	4,447
2008	4,106
2009	3,717
2010	1,777
Total	$ 15,227

As described in Note 2 to our consolidated financial statements in our most recently filed Annual Report on Form 10-K, our existing *Carter s* tradename and cost in excess of fair value of net assets acquired have been deemed to have indefinite lives and are not being amortized. During the three-month period ended September 30, 2006, approximately $2.7 million related to tax contingencies established in connection with the 2001 Acquisition of the Company by Berkshire Partners LLC (the 2001 Acquisition) were reversed due to the closure of certain tax periods. This reversal resulted in a corresponding adjustment to cost in excess of fair value of net assets acquired of $2.7 million in accordance with EITF 93-7.

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NOTE 5 INVENTORIES:

Inventories consisted of the following:

(dollars in thousands)	September 30, 2006	December 31, 2005
Finished goods	$ 199,849	$ 185,472
Work in process		2,336
Raw materials and supplies		646
Total	$ 199,849	$ 188,454

NOTE 6 CREDIT FACILITY AMENDMENT:

On April 28, 2006, the Company entered into Amendment No. 1 (Amendment No. 1) to the Senior Credit Facility. Amendment No. 1 reduced the Company s interest rate by refinancing the existing Term Loan B (initially priced at LIBOR + 1.75% with a leverage-based pricing grid ranging from LIBOR + 1.50% to LIBOR + 1.75%) with a new Term Loan 1 having an applicable rate of LIBOR + 1.50% with no leverage-based pricing grid. If the Company makes any optional prepayments of its Term 1 Loans prior to the one-year anniversary of Amendment No. 1 in connection with any repricing transaction, the Company will be required to pay a prepayment premium of 1% of the amount of such Term 1 Loans being prepaid.

Amendment No. 1 also lowered the threshold for permitting restricted payments by raising the required leverage ratio (as defined) from 1.5 times to 2.5 times provided the Company has revolving loan commitments of $75.0 million available.

NOTE 7 EMPLOYEE BENEFIT PLANS:

Under a defined benefit plan, which was frozen in 1991, we offer a comprehensive post-retirement medical plan to current and certain future retirees and their spouses until they become eligible for Medicare or a Medicare supplement plan. We also offer life insurance to current and certain future retirees.

The components of post-retirement life and medical benefit expense charged to operations are as follows:

	For the three-month periods ended		For the nine-month periods ended	
(dollars in thousands)	**September 30, 2006**	**October 1, 2005**	**September 30, 2006**	**October 1, 2005**
Service cost benefits attributed to service during the period	$ 42	$ 25	$ 126	$ 75
Interest cost on accumulated post-retirement benefit obligation	160	171	477	504
Amortization of prior service cost	23		69	
Total net periodic pension benefit cost	$ 225	$ 196	$ 672	$ 579

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We also have an obligation under a defined benefit plan covering certain former officers. The components of pension expense charged to operations related to this plan are as follows:

(dollars in thousands)	For the three-month periods ended September 30, 2006	October 1, 2005	For the nine-month periods ended September 30, 2006	October 1, 2005
Interest cost on accumulated pension benefit obligation	$ 19	$ 20	$ 57	$ 60

The Company maintains two defined benefit pension plans acquired in connection with the Acquisition. The benefits under these pension plans were frozen as of December 31, 2005, and cover certain current and former employees of OshKosh.

The Company s net periodic pension benefit related to these plans is comprised of the following components:

(dollars in thousands)	For the three-month periods ended September 30, 2006	October 1, 2005	For the nine-month periods ended September 30, 2006	October 1, 2005
Service cost	$ -	$ 56	$ -	$ 56
Interest cost	650	735	1,951	735
Expected return on assets	(1,035)	(926)	(3,104)	(926)
Net periodic pension benefit	$ (385)	$ (135)	$ (1,153)	$ (135)

See Note 7 Employee Benefit Plans to our consolidated financial statements in our most recently filed Annual Report on Form 10-K for further information.

NOTE 8 COMMON STOCK:

On May 12, 2006, the Company amended Article V of its certificate of incorporation. The amendment increased the number of authorized shares of the Company s common stock from 40,000,000 to 150,000,000.

On June 6, 2006, the Company effected a two-for-one stock split (the stock split) through a stock dividend to stockholders of record as of May 23, 2006, of one share of our common stock for each share of common stock outstanding. Earnings per share for all prior periods presented have been adjusted to reflect the stock split.

During the first nine months of fiscal 2006, we issued 17,172 shares of common stock to our non-management board members.

NOTE 9 STOCK-BASED COMPENSATION:

Under our Amended and Restated 2003 Equity Incentive Plan (the Plan), the compensation committee of our Board of Directors may award incentive stock options (ISOs and non-ISOs), stock appreciation rights (SARs), restricted stock, unrestricted stock, stock deliverable on a deferred basis, performance-based stock awards, and cash payments intended to help defray the cost of awards. All share and per share amounts have been adjusted to reflect the stock split discussed in Note 8 above.

On May 12, 2005, our Board of Directors implemented, and our stockholders approved an amendment to the Plan to increase the number of shares available to be delivered under the Plan by 2,800,000 to 11,488,392, with no more than 1,260,000 of such additional shares able to be used for awards other than stock options and to reduce the number of shares for which stock options may be granted to any individual or which can be subject to SARs granted to any individual in any calendar year from 8,000,000 to 2,000,000. As of September 30, 2006, there were 2,192,284 shares available for grant under the Plan. The Plan makes provision for the treatment of awards upon termination of service or in the case of a merger or similar corporate transaction. Participation in the Plan is limited to Directors and those key employees selected by the compensation committee. The limit on shares available under the Plan, the individual limits, and other award terms are subject to adjustment to reflect stock splits or stock dividends, combinations, and certain other events. All stock options issued under the Plan expire no later than ten years from the date of grant. The Company believes that the current level of authorized shares is sufficient to satisfy future option exercises.

There are currently three types of stock options outstanding under the Plan: basic, performance, and retained options. Basic options issued prior to May 12, 2005 vest in equal annual installments over a five-year period. Basic options granted on and subsequently to May 12, 2005 vest in equal annual installments over a four-year period. Performance options vest upon the achievement of pre-determined performance criteria. Retained stock options are options that were outstanding prior to the Company s 2001 acquisition by Berkshire Partners LLC and became fully vested in connection with the 2001 acquisition.

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123R), which replaced SFAS 123, Accounting for Stock-Based Compensation (SFAS 123) as amended by SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure (SFAS 148), and supercedes Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25). SFAS 123R requires companies to expense the fair value of employee stock options and similar awards. Effective January 1, 2006, the Company adopted SFAS 123R and began recognizing compensation expense for its share-based payments based on the fair value of the awards at the grant date. Under SFAS 123R, the pro forma disclosures previously permitted under SFAS 123 are no longer an alternative to financial statement recognition.

The Company adopted SFAS 123R using the modified prospective application method of transition. Therefore, prior period financial statements have not been restated. Under the modified prospective application method, for awards granted prior to January 1, 2006, compensation expense is recorded as options vest subsequent to January 1, 2006 based upon the grant-date fair value estimated in accordance with the original provisions of SFAS 123, adjusted for estimated forfeitures. For stock options granted subsequent to January 1, 2006, compensation expense will be recorded as options vest based upon the grant-date fair value estimated in accordance with SFAS 123R, with forfeitures estimated at the time of grant. Forfeiture estimates will be adjusted periodically based on the extent to which actual forfeitures differ, or are expected to differ, from previous estimates.

The fair value of stock options under SFAS 123R is determined using the Black-Scholes option pricing model, which is consistent with our valuation techniques previously utilized for stock options in pro forma footnote disclosure required under SFAS 123. Prior to the filing of our first Registration Statement on Form S-1 on August 23, 2002 in connection with our initial public offering, we used the minimum value method to value stock options, as provided by SFAS 123, as amended by SFAS 148. Under SFAS 123R, no compensation expense has been recorded for options recorded under the minimum value method.

The fair value of restricted stock is determined based on the number of shares granted and the quoted closing price of our common stock on the date of grant, consistent with our treatment of such awards under APB 25 prior to the adoption of SFAS 123R.

In connection with the adoption and provisions of SFAS 123R, the Company reversed its deferred compensation balance of $2,749,000 on January 1, 2006 related to restricted stock awards.

The adoption of SFAS 123R has resulted in additional pre-tax, share-based compensation expense (a component of selling, general, and administrative expenses) in the amount of approximately $984,000 and $2.9 million related to stock options for the three and nine-month periods ended September 30, 2006, than if the Company had continued to account for share-based compensation under APB 25. The impact on net income for the three-month period ended September 30, 2006 was a reduction of approximately $612,000, or $0.01, on both basic and diluted earnings per share. The impact on net income for the nine-month period ended September 30, 2006 was a reduction of approximately $1.8 million, or $0.03, on both basic and diluted earnings per share. For the fiscal year ended December 30, 2006, the adoption of SFAS 123R is expected to result in a reduction in net income of approximately $2.4 million, or $0.04 per basic and diluted earnings per share.

Prior to the adoption of SFAS 123R, we presented all tax benefits resulting from the exercise of stock options as operating cash inflows in the consolidated statements of cash flows, in accordance with the provisions of EITF Issue No. 00-15, Classification in the Statement of Cash Flows of the Income Tax Benefit Received by a Company upon Exercise of a Nonqualified Employee Stock Option. SFAS 123R requires the benefit of tax deductions in excess of the compensation cost recognized for exercised options and restricted stock that vests to be classified as financing cash inflows rather than operating cash inflows, on a prospective basis. This amount is now shown as Income tax benefit from exercised stock options on the accompanying unaudited condensed consolidated statement of cash flows. The income tax benefit from exercised stock options during the nine-month period ended September 30, 2006 was approximately $2.5 million. Prior periods have not been restated.

Prior to the adoption of SFAS 123R, we accounted for stock-based compensation on stock options under the intrinsic value method consistent with APB 25. Under this method, we recorded compensation expense equal to the difference between the exercise price of the stock option and the fair market value of the underlying stock as of the date of the option grant. Forfeitures on stock option awards with expense recorded in accordance with APB 25 were accounted for as they occurred, rather than based on estimates of future forfeitures. There was no material impact or cumulative effect adjustment required as a result of estimating the impact of future forfeitures on awards previously expensed in accordance with APB 25. For disclosure purposes only, we also estimated the impact on our net income of applying the fair value method of measuring compensation cost on stock options with the fair value of the Company s common stock. In our pro forma disclosure we accounted for forfeitures as they occurred, rather than based on estimates of future forfeitures.

The following table provides supplemental information for the three and nine-month periods ended October 1, 2005 as if stock-based compensation had been computed under SFAS 123, as amended by SFAS 148:

(dollars in thousands, except per share data)	**For the three-month period ended October 1, 2005**	**For the nine-month period ended October 1, 2005**
Net income, as reported	$ 10,578	$ 29,877
Add:		
Stock-based employee compensation (under APB 25) included in reported net income, net of related tax effects	278	755
Deduct:		
Total stock-based employee compensation expense determined under the fair value based method (under SFAS 123 and SFAS 148) for all awards, net of related tax effects	(669)	(1,850)
Pro forma net income	$ 10,187	$ 28,782
Net income per common share:		
Basic-as reported	$ 0.18	$ 0.52
Basic-pro forma	$ 0.18	$ 0.50
Diluted-as reported	$ 0.17	$ 0.49
Diluted-pro forma	$ 0.17	$ 0.47

A summary of stock option activity under the Plan (in number of shares that may be purchased) is as follows for the nine-month period ended September 30, 2006:

Basic Stock Options

	Basic stock options	**Weighted-average exercise price per share**	**Weighted-average grant-date fair value**
Outstanding, December 31, 2005	4,844,128	$ 6.23	$ 2.76
Granted	184,600	$ 33.73	$ 15.34
Exercised	(252,288)	$ 4.31	$ 2.09
Forfeited	(17,000)	$ 31.43	$ 12.66
Expired		$	$
Outstanding, September 30, 2006	4,759,440	$ 7.30	$ 3.25
Exercisable, September 30, 2006	3,728,300	$ 4.21	$ 1.86

During the nine months ended September 30, 2006, the Company granted 184,600 basic stock options. In connection with this grant of basic stock options, the Company recognized approximately $350,000 in compensation expense during the nine-month period ended September 30, 2006.

A summary of basic stock options outstanding and exercisable at September 30, 2006 is as follows:

	Outstanding				Exercisable			
Range of exercise prices	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date fair value**	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date fair value**
$ 3 -$ 5	3,373,128	5.02 years	$ 3.14	$ 1.29	3,299,688	4.99 years	$ 3.11	$ 1.29
$ 6 -$ 7	317,392	6.96 years	$ 6.98	$ 4.88	159,632	6.96 years	$ 6.98	$ 4.88
$13 -$17	619,920	7.60 years	$ 14.88	$ 6.71	228,480	7.58 years	$ 14.81	$ 6.66
$22 -$27	240,000	8.80 years	$ 23.82	$ 9.52	35,000	8.63 years	$ 22.10	$ 8.75
$31 -$35	209,000	9.36 years	$ 33.47	$ 15.03	5,500	8.83 years	$ 31.43	$ 12.66
	4,759,440	5.87 years	$ 7.30	$ 3.25	3,728,300	5.28 years	$ 4.21	$ 1.86

At September 30, 2006, the aggregate intrinsic value of all outstanding basic options was approximately $92.3 million and the aggregate intrinsic value of currently exercisable basic options was approximately $82.7 million. The intrinsic value of basic options exercised during the three and nine-month periods ended September 30, 2006 was approximately $277,000 and $7.0 million. At September 30, 2006, the total estimated compensation cost related to non-vested basic options not yet recognized was approximately $6.8 million with a weighted-average expense recognition period of 2.83 years.

Performance Stock Options

	Performance stock options	Weighted-average exercise price per share	Weighted-average grant-date fair value
Outstanding, December 31, 2005	600,000	$ 25.06	$ 9.40
Granted	20,000	$ 24.20	$ 11.19
Exercised		$	$
Forfeited		$	$
Expired		$	$
Outstanding, September 30, 2006	620,000	$ 25.04	$ 9.46
Exercisable, September 30, 2006		*$*	*$*

During the three and nine months ended September 30, 2006, the Company granted 20,000 performance stock options. In connection with this grant of performance stock options, the Company recognized approximately $2,900 in compensation expense during the three and nine-month periods ended September 30, 2006.

A summary of performance stock options outstanding and exercisable at September 30, 2006 is as follows:

	Outstanding				Exercisable			
Range of exercise prices	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date fair value**	**Number**	**Weighted-average remaining contractual life**	**Weighted-average exercise price**	**Weighted-average grant-date fair value**
$22-$32	620,000	8.82 years	$ 25.04	$ 9.46			$	$

At September 30, 2006, the aggregate intrinsic value of all outstanding performance options was approximately $1.8 million. No performance options are currently exercisable. At September 30, 2006, the total estimated compensation cost related to non-vested performance options not yet recognized was approximately $4.2 million with a weighted-average expense recognition period of 2.90 years.

Retained Stock Options

	Retained stock options	Weighted-average exercise price per share
Outstanding, December 31, 2005	1,708,270	$ 0.75
Granted		$
Exercised		$
Forfeited		$
Expired		$
Outstanding, September 30, 2006	1,708,270	$ 0.75
Exercisable, September 30, 2006	1,708,270	$ 0.75

The weighted-average contractual life of the 1,708,270 retained stock options outstanding and exercisable as of September 30, 2006 is 4.88 years. At September 30, 2006, the aggregate intrinsic value of all outstanding retained options, which are all currently exercisable, was approximately $43.8 million.

The weighted-average contractual life for the basic, performance, and retained stock options in aggregate as of September 30, 2006 was approximately 5.89 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing method with the following weighted-average assumptions used for grants issued during the nine-month period ended September 30, 2006:

	For the nine-month period ended September 30, 2006	
Volatility	38.97	%
Risk-free interest rate	4.70	%
Expected term (years)	6.0	
Dividend yield		

Volatility This is a measure of the amount by which a stock price has fluctuated or is expected to fluctuate. The Company uses actual monthly historical changes in the market value of our stock since the Company s initial public offering on October 29, 2003, supplemented by peer company data for periods prior to our initial public offering covering the expected life of options being valued. An increase in the expected volatility will increase compensation expense.

Risk-free interest rate This is the U.S. Treasury rate as of the grant date having a term equal to the expected term of the option. An increase in the risk-free interest rate will increase compensation expense.

Expected term This is the period of time over which the options granted are expected to remain outstanding and is based on historical experience and estimated future exercise behavior. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. An increase in the expected term will increase compensation expense.

Dividend yield The Company does not have plans to pay dividends in the foreseeable future. An increase in the dividend yield will decrease compensation expense.

Restricted Stock

All restricted stock awards issued under the Plan vest based upon continued service. Restricted stock awards vest in equal annual installments over a four-year period or cliff vest after a three or four-year period. As noted above, the fair value of restricted stock is determined based on the number of shares granted and the quoted closing price of our common stock on the date of grant.

The following table summarizes our restricted stock award activity during the nine-month period ended September 30, 2006:

	Restricted stock
Outstanding, December 31, 2005	134,270
Granted	100,200
Vested	(4,750)
Forfeited	(8,000)
Outstanding, September 30, 2006	221,720

During the three-month period ended September 30, 2006, the Company granted 10,000 shares of restricted stock to an employee. In connection with this issuance, we recorded approximately $3,300 of compensation expense.

During the nine-month period ended September 30, 2006, the Company granted 100,200 shares of restricted stock to employees. Compensation expense recorded during the nine-month period ended September 30, 2006 for all restricted stock awards totaled approximately $987,000. The total amount of estimated compensation expense related to unvested restricted stock awards is approximately $4.6 million as of September 30, 2006.

Unrecognized stock-based compensation expense related to outstanding stock options and restricted stock awards is expected to be recorded as follows:

(dollars in thousands)	**Basic options**	**Performance options**	**Restricted stock**	**Total**
2006 (period from October 1 through December 30)	$ 626	$ 378	$ 389	$ 1,393
2007	2,496	1,516	1,554	5,566
2008	2,383	1,516	1,526	5,425
2009	1,218	740	1,059	3,017
2010	103	90	115	308
Total	$ 6,826	$ 4,240	$ 4,643	$ 15,709

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NOTE 10 SEGMENT INFORMATION:

We report segment information in accordance with the provisions of SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, which requires segment information to be disclosed based upon a management approach. The management approach refers to the internal reporting that is used by management for making operating decisions and assessing the performance of our operating segments.

The table below presents certain segment information for the periods indicated:

	For the three-month periods ended				**For the nine-month periods ended**			
	September 30, 2006	**% of Total**	**October 1, 2005 (a)**	**% of Total**	**September 30, 2006**	**% of Total**	**October 1, 2005 (a)**	**% of Total**
Net sales:								
Wholesale-Carter s	$ 143,624	36.6 %	$ 130,757	35.1 %	$ 330,080	34.2 %	$ 315,757	41.0 %
Wholesale-OshKosh	25,778	6.6 %	32,644	8.8 %	74,870	7.8 %	32,644	4.2 %
Retail-Carter s	93,493	23.9 %	87,664	23.5 %	233,956	24.2 %	222,925	28.9 %
Retail-OshKosh	62,739	16.0 %	63,500	17.1 %	155,754	16.1 %	63,500	8.2 %
Mass Channel-Carter s	66,343	16.9 %	57,593	15.5 %	171,341	17.7 %	136,039	17.7 %
Total net sales	$ 391,977	100.0 %	$ 372,158	100.0 %	$ 966,001	100.0 %	$ 770,865	100.0 %

		% of net sales		**% of net sales**		**% of net sales**		**% of net sales**
Operating income:								
Wholesale-Carter s	$ 32,750	22.8 %	$ 28,093	21.5 %	$ 66,170	20.0 %	$ 61,070	19.3 %
Wholesale-OshKosh	3,806	14.8 %	1,231 (b)	3.8 %	8,396	11.2 %	1,231 (b)	3.8 %
Retail-Carter s	17,435	18.6 %	20,941	23.9 %	37,780	16.1 %	43,589	19.6 %
Retail-OshKosh	7,444	11.9 %	949 (c)	1.5 %	10,276	6.6 %	949 (c)	1.5 %
Mass Channel-Carter s	10,746	16.2 %	7,302	12.7 %	24,644	14.4 %	14,117	10.4 %
Mass Channel-OshKosh (d)	604		63		1,440		63	
Segment operating Income	72,785	18.6 %	58,579	15.7 %	148,706	15.4 %	121,019	15.7 %
Other reconciling items	(11,279)	(2.9)%	(13,522)(e)	(3.6)%	(33,512)	(3.5)%	(35,604)(e)	(4.6)%
Total operating Income	$ 61,506	15.7 %	$ 45,057	12.1 %	$ 115,194	11.9 %	$ 85,415	11.1 %

(a) Financial results for the three and nine-month periods ended October 1, 2005 include the operations of OshKosh for the period from July 14, 2005 through October 1, 2005.

(b) The three and nine-month periods ended October 1, 2005 include a charge of $3.3 million related to the amortization of a fair value step-up for wholesale inventory acquired from OshKosh.

(c) The three and nine-month periods ended October 1, 2005 include a charge of $7.1 million related to the amortization of a fair value step-up for retail store inventory acquired from OshKosh.

(d) OshKosh mass channel consists of a licensing agreement with Target Stores. Operating income consists of royalty income, net of related expenses.

(e) The three and nine-month periods ended October 1, 2005 include $1.5 million and $6.1 million, respectively, of charges related to the closure of the Company s sewing facilities in Mexico.

NOTE 11 RESTRUCTURING AND CLOSURE COSTS:

In connection with the Acquisition, management has developed a plan to restructure and integrate the operations of OshKosh. In accordance with EITF No. 95-3, Recognition of Liabilities in Connection with a Purchase Business Combination, liabilities have been established for OshKosh severance and relocation, lease termination costs associated with the closure of OshKosh s 15 Lifestyle stores and 14 outlet stores in fiscal 2005, one outlet store closure in fiscal 2006, contract termination costs, and other exit costs. These liabilities also cover costs related to the closure of the OshKosh Choloma, Honduras sewing facility, Uman, Mexico sewing facility, and Liberty, Kentucky distribution center. The Choloma, Honduras and Liberty, Kentucky facilities were closed during the fourth quarter of fiscal 2005. The Uman, Mexico facility was closed during the first quarter of fiscal 2006. We expect to pay these liabilities during fiscal 2006 and the first half of fiscal 2007.

The following table summarizes restructuring activity related to the Acquisition:

(dollars in thousands)	Severance and relocation	Other exit costs	Lease termination costs	Contract termination costs	Total
Balance at July 14, 2005	$ 9,840	$ 2,075	$ 7,020	$ 2,000	$ 20,935
Payments	(2,304)	(71)	(468)	(934)	(3,777)
Adjustments to cost in excess of fair value of net assets acquired	673	(78)		(168)	427
Balance at December 31, 2005	8,209	1,926	6,552	898	17,585
Payments	(4,687)	(1,349)	(4,068)	(399)	(10,503)
Adjustments to cost in excess of fair value of net assets acquired	(780)	170	180	(299)	(729)
Balance at September 30, 2006	$ 2,742	$ 747	$ 2,664	$ 200	$ 6,353

In May 2005, we decided to exit two sewing facilities in Mexico. The total number of employees initially terminated was approximately 1,124. Production at these facilities ceased on August 5, 2005. As a result of these closures, in fiscal 2005, we recorded total charges of $8.4 million, including $4.6 million of severance charges, $1.3 million of lease termination charges, $1.6 million of accelerated depreciation (included in cost of goods sold), $0.1 million of asset impairment charges, and $0.8 million of other exit costs. During the first nine months of fiscal 2005, we recorded total charges of $7.6 million, including $4.2 million of severance charges, $1.3 million of lease termination costs, $1.6 million of accelerated depreciation (included in cost of goods sold), $0.1 million of asset impairment charges, and $0.4 million of other exit costs. During the first nine months of fiscal 2006, we recorded total charges of $91,000, including $74,000 of severance charges and $17,000 of other exit costs.

Restructuring provisions recorded as a result of these closures are as follows and are included in other current liabilities on the accompanying unaudited condensed consolidated balance sheet:

(dollars in thousands)	December 31, 2005 reserves	Provisions	Payments	September 30, 2006 reserves
Severance and other termination benefits	$ 370	$ 74	$ (266)	$ 178
Lease termination costs	813		(752)	61
Other exit costs	150	17	(167)	
Total	$ 1,333	$ 91	$ (1,185)	$ 239

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NOTE 12 EARNINGS PER SHARE:

In accordance with SFAS No. 128, Earnings Per Share, basic earnings per share is based on the weighted-average number of common shares outstanding during the year, whereas diluted earnings per share also gives effect to all potentially dilutive shares of common stock, including basic and retained stock options and unvested restricted stock, that were outstanding during the period. Share and per share amounts for prior periods have been adjusted to reflect the stock split described in Note 8. All such stock options are reflected in the denominator using the treasury stock method. This method assumes that shares are issued for stock options that are in the money, but that we use the proceeds of such stock option exercises (generally, cash to be paid plus future compensation expense to be recognized and the amount of tax benefits, if any, that will be credited to additional paid-in capital assuming exercise of the stock options) to repurchase shares at the average market value of Carter s, Inc. s stock for the respective periods. Unvested shares of restricted stock are reflected in the denominator using the treasury stock method with proceeds of the amount, if any, the employees must pay upon vesting, the amount of compensation cost attributed to future services and not yet recognized in earnings, and the amount of tax benefits, if any, that would be credited to additional paid-in capital (i.e., the amount of the tax deduction in excess of recognized compensation cost) assuming vesting of the shares at the current market price.

For the three and nine-month periods ended September 30, 2006, anti-dilutive shares of 545,950 and 315,750, respectively, and performance-based options of 620,000, were excluded from the computations of diluted earnings per share. For the three and nine-month periods ended October 1, 2005, anti-dilutive shares of 56,000 and 148,000 respectively, and performance based options of 400,000, were excluded from the computation of diluted earnings per share.

The following is a reconciliation of basic common shares outstanding to diluted common and common equivalent shares outstanding:

	For the three-month periods ended		**For the nine-month periods ended**	
	September 30, 2006	**October 1, 2005**	**September 30, 2006**	**October 1, 2005**
Net income	$ 34,977,000	$ 10,578,000	$ 59,781,000	$ 29,877,000
Weighted-average number of common and common equivalent shares outstanding:				
Basic number of common shares outstanding	57,949,783	57,439,850	57,845,521	57,177,740
Diluted effect of unvested restricted stock	35,400	20,554	65,310	1,868
Dilutive effect of stock options	3,108,958	3,471,652	3,262,416	3,493,012
Diluted number of common and common equivalent shares outstanding	61,094,141	60,932,056	61,173,247	60,672,620
Basic net income per common share	$ 0.60	$ 0.18	$ 1.03	$ 0.52
Diluted net income per common share	$ 0.57	$ 0.17	$ 0.98	$ 0.49