

SOLA INTERNATIONAL INC

Form 10-Q

October 29, 2003

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**  
**FORM 10-Q**

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2003

or

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

Commission File Number 1-13606

**SOLA INTERNATIONAL INC.**

(Exact name of registrant as specified in its charter)

DELAWARE  
(State or other jurisdiction of  
incorporation or organization)

94-3189941  
(I.R.S. employer identification no.)

10590 West Ocean Air Drive, Suite 300, San Diego, CA 92130  
(Address of principal executive offices)  
(zip code)

(858) 509-9899  
(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 ( )

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

As of October 24, 2003, 24,947,082 shares of the registrant's common stock, par value \$0.01 per share, which is the only class of common stock of the registrant, were outstanding.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****SOLA INTERNATIONAL INC.****Consolidated Balance Sheets**  
**(in thousands, except per share data)**

	<b>September 30, 2003 (unaudited)</b>	<b>March 31, 2003</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 59,771	\$ 58,679
Trade accounts receivable, less allowance for doubtful accounts of \$7,973 and \$8,972 at September 30, 2003 and March 31, 2003, respectively	124,723	123,088
Inventories	101,776	91,442
Deferred taxes, current	27,081	25,065
Prepaid and other current assets	21,188	13,095
	<hr/>	<hr/>
Total current assets	334,539	311,369
Property, plant and equipment, net	176,982	171,653
Goodwill	210,517	208,794
Deferred taxes, long-term	37,725	40,155
Other long-term assets	23,702	27,108
	<hr/>	<hr/>
Total assets	\$ 783,465	\$ 759,079
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Notes payable to banks	\$	\$ 522
Current portion of long-term debt	2,965	3,510
Accounts payable	56,900	64,157
Accrued liabilities	43,619	40,615
Accrued payroll and related compensation	28,595	29,368
Deferred taxes, current	639	1,584
	<hr/>	<hr/>
Total current liabilities	132,718	139,756
Long-term debt, less current portion	5,789	5,962
Senior notes	330,136	318,242
Deferred taxes, long-term	14,962	14,913
Other long-term liabilities	16,208	18,249
	<hr/>	<hr/>
Total liabilities	499,813	497,122
	<hr/>	<hr/>
Contingencies		
Stockholders' equity:		
Preferred stock, \$0.01 par value; 5,000 shares authorized; no shares issued		
Common stock, \$0.01 par value; 50,000 shares authorized; 25,315 and 24,996 shares issued and 24,947 and 24,628 shares outstanding as of September 30, 2003 and March 31, 2003, respectively	253	250

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Additional paid-in capital	289,793	286,677
Retained earnings	32,673	25,472
Cumulative other comprehensive loss	(36,680)	(48,055)
Common stock in treasury, at cost 368 shares at September 30, 2003 and March 31, 2003	(2,387)	(2,387)
	<u>283,652</u>	<u>261,957</u>
Total stockholders' equity		
	<u>\$783,465</u>	<u>\$759,079</u>
Total liabilities and stockholders' equity		

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

**Table of Contents****SOLA INTERNATIONAL INC.****Unaudited Consolidated Statements of Operations**  
(in thousands, except per share data)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2003	2002	2003	2002
Net sales	\$ 158,663	\$ 138,486	\$ 312,642	\$ 273,663
Cost of sales	95,989	82,321	187,607	162,082
<b>Gross profit</b>	<b>62,674</b>	<b>56,165</b>	<b>125,035</b>	<b>111,581</b>
Research and development expenses	2,419	3,232	4,902	6,477
Selling and marketing expenses	28,347	25,979	56,332	52,000
General and administrative expenses	11,269	11,961	23,346	23,083
<b>Operating expenses</b>	<b>42,035</b>	<b>41,172</b>	<b>84,580</b>	<b>81,560</b>
<b>Operating income</b>	<b>20,639</b>	<b>14,993</b>	<b>40,455</b>	<b>30,021</b>
Interest income	345	377	735	863
Interest expense	(9,165)	(8,183)	(18,389)	(16,008)
Foreign currency gain/(loss)	(2,184)	2,237	(12,165)	(12,652)
<b>Income before provision for income taxes and minority interest</b>	<b>9,635</b>	<b>9,424</b>	<b>10,636</b>	<b>2,224</b>
Provision for income taxes	(2,795)	(2,827)	(3,085)	(667)
Minority interest	(157)	(67)	(350)	(379)
<b>Net income</b>	<b>\$ 6,683</b>	<b>\$ 6,530</b>	<b>\$ 7,201</b>	<b>\$ 1,178</b>
<b>Net income per share - basic</b>	<b>\$ 0.27</b>	<b>\$ 0.27</b>	<b>\$ 0.29</b>	<b>\$ 0.05</b>
Weighted average common shares outstanding	24,905	24,557	24,814	24,550
<b>Net income per share - diluted</b>	<b>\$ 0.26</b>	<b>\$ 0.26</b>	<b>\$ 0.29</b>	<b>\$ 0.05</b>
Weighted average common and dilutive securities outstanding	25,294	24,781	25,192	24,835

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

**Table of Contents****SOLA INTERNATIONAL INC.****Unaudited Consolidated Statements of Cash Flows**  
(in thousands)

	Six Months Ended September 30,	
	2003	2002
<b>Cash flows from operating activities:</b>		
Net income	\$ 7,201	\$ 1,178
Adjustments to reconcile net income to net cash provided by operating activities:		
Minority interest in earnings	350	379
Depreciation	11,588	10,337
Amortization- debt issuance costs	1,650	1,516
Amortization- other intangibles	162	19
Provision for doubtful accounts	343	876
Tax benefit from exercise of stock options	483	34
Deferred taxes	(212)	349
Foreign currency loss	13,889	16,079
(Gain)/loss on disposal/sale of property, plant and equipment	(1)	63
Changes in assets and liabilities, net of acquisitions:		
Trade accounts receivable	3,362	886
Inventories	(6,182)	(11,904)
Prepaid and other assets	(9,028)	(4,758)
Accounts payable	(14,141)	(8,248)
Accrued and other current liabilities	(80)	(2,764)
Other long-term liabilities	(2,969)	24
	<u>6,415</u>	<u>4,066</u>
Net cash provided by operating activities		
<b>Cash flows from investing activities:</b>		
Purchases of businesses	(888)	(17,238)
Disposal of joint ventures	1,635	(35)
Capital expenditures	(6,753)	(9,177)
Mold expenditures	(2,131)	(1,221)
Other investing activities	271	251
	<u>(7,866)</u>	<u>(27,420)</u>
Net cash used in investing activities		
<b>Cash flows from financing activities:</b>		
Proceeds from the exercise of stock options	2,767	330
Net payments under notes payable to banks	(522)	(22)
Borrowings on long-term debt	1,218	528
Payments on long-term debt	(2,471)	(1,283)
	<u>992</u>	<u>(447)</u>
Net cash provided by/(used in) financing activities		
Effect of exchange rate changes on cash and cash equivalents	1,551	1,529
Net increase/(decrease) in cash and cash equivalents	1,092	(22,272)
Cash and cash equivalents at beginning of period	58,679	68,419



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Cash and cash equivalents at end of period	<u>\$ 59,771</u>	<u>\$ 46,147</u>
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The accompanying notes are an integral part of these consolidated financial statements

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**SOLA INTERNATIONAL INC.**

**Notes to Consolidated Financial Statements  
(unaudited)**

**1. Basis of Presentation**

SOLA International Inc. (the Company) designs, manufactures and distributes a broad range of eyeglass lenses, primarily focusing on the fast growing plastic lens segment of the global market. The Company operates in one business segment.

The accompanying consolidated financial statements of the Company have been prepared without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures 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 such rules and regulations. The condensed consolidated balance sheet at March 31, 2003 has been derived from audited financial statements. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's annual report on Form 10-K for the fiscal year ended March 31, 2003.

The financial information included herein reflects all adjustments (consisting of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the results for the interim period. The results of operations for the six months ended September 30, 2003 are not necessarily indicative of the results to be expected for the full year. Certain prior year items have been reclassified to conform to the current year's presentation. These reclassifications had no impact on previously reported net income/loss.

In order to continue its operations and meet its significant liquidity requirements, the Company must maintain profitable operations or obtain additional funds through equity or debt financing, bank financing, and other sources. Management believes that its existing cash balances, foreign credit facilities, internally generated funds and other potential financing alternatives will be sufficient to meet the Company's capital, operating and debt service requirements for at least the next twelve months. If the Company is unable to generate adequate cash flow from sales of its products, the Company may need to seek additional sources of capital. There can be no assurance that the Company will be able to obtain additional debt or equity financing on terms acceptable to the Company, or at all. If adequate funds are not available, the Company could be required to delay development or commercialization of certain products, or reduce the marketing, customer support, or other resources devoted to product development. Accordingly, the failure of the Company to obtain sufficient funds on acceptable terms when needed could have a material adverse effect on the Company's business, results of operations and financial condition.

**2. Impact of Recently Issued Accounting Standards**

In November 2002, the Emerging Issues Task Force (EITF) reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of this standard had no material impact on the Company's financial statements.

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In January 2003, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 46 ( FIN 46 ), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 applied for the first interim or annual period beginning after December 15, 2003. The adoption of this standard had no material impact on the Company's financial statements.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities ( SFAS 149 ). SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts. SFAS 149 is effective for contracts entered into or modified after June 30, 2003. The adoption of this standard had no material impact on its financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity ( SFAS 150 ). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this standard had no material impact on the Company's financial position, results of operations, or cash flows.

**3. Accounting for Stock-Based Compensation**

The Company records compensation expense for employee stock options based upon their intrinsic value on the date of grant pursuant to Accounting Principles Board Opinion No. 25 ( APB 25 ), Accounting for Stock Issued to Employees. Because the Company establishes the exercise price based on the fair market value of the Company's stock at the date of grant, the options have no intrinsic value upon grant, and therefore no expense is recorded. Each quarter, the Company reports the potential dilutive impact of stock options in its diluted earnings per share using the treasury-stock method. Out-of-the-money stock options (i.e., the average stock price during the period is below the exercise price of the option) are not included in diluted earnings per share.

As required under SFAS No. 123 ( SFAS 123 ), Accounting for Stock-Based Compensation, and SFAS No. 148 ( SFAS 148 ), Accounting for Stock-Based Compensation - Transition and Disclosure, the pro forma effects of stock-based compensation on net income/(loss) and net income/(loss) per common share have been estimated at the date of grant using the Black-Scholes option-pricing model.

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For purposes of pro forma disclosures, the estimated fair value of the options is assumed to be amortized to expense over the options vesting periods. The pro forma effects of recognizing compensation expense under the fair value method on net income and net income per common share were as follows:

	Three Months Ended September 30,		Six Months Ended September 30,	
	2003	2002	2003	2002
	(in thousands, except per share data)			
Net income, as reported	\$ 6,683	\$ 6,530	\$ 7,201	\$ 1,178
Deduct: Stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effect	(452)	(567)	(808)	(1,169)
Pro forma net income	\$ 6,231	\$ 5,963	\$ 6,393	\$ 9
Net income per share:				
Basic, as reported	\$ 0.27	\$ 0.27	\$ 0.29	\$ 0.05
Basic, pro forma	\$ 0.25	\$ 0.24	\$ 0.26	\$ 0.00
Diluted, as reported	\$ 0.26	\$ 0.26	\$ 0.29	\$ 0.05
Diluted, pro forma	\$ 0.25	\$ 0.24	\$ 0.25	\$ 0.00

The pro forma effect of SFAS No. 123 on net income may not be representative of the effects on pro forma net income in future periods.

**4. Inventories**

The following is the detail of inventories (in thousands):

	September 30, 2003	March 31, 2003
Raw Materials	\$ 12,385	\$ 13,611
Work In Progress	3,007	3,124
Finished Goods	86,384	74,707
	\$ 101,776	\$ 91,442

**Table of Contents****5. Accrued Liabilities**

The following is the detail of accrued liabilities (in thousands):

	<u>September 30, 2003</u>	<u>March 31, 2003</u>
Liabilities associated with strategic initiatives	\$ 286	\$ 870
Marketing and promotional accrual	12,868	12,632
Other accrued liabilities	30,465	27,113
	<u>\$ 43,619</u>	<u>\$ 40,615</u>

Commencing in the third quarter of fiscal 1999, the Company implemented strategic initiatives designed to streamline manufacturing and logistics, reduce operating costs worldwide and write-off inventory SKUs that are no longer being manufactured. No special charges were recorded during the six months ended September 30, 2003 and 2002. The following table reconciles the remaining liabilities associated with the strategic initiatives from March 31, 2003 to September 30, 2003 (in thousands):

	<u>Workforce Reductions</u>	<u>Facility Closures</u>	<u>Total</u>
Strategic initiative liability as of March 31, 2003	\$ 651	\$ 219	\$ 870
Fiscal 2004 six months cash utilized	(517)	(67)	(584)
	<u>\$ 134</u>	<u>\$ 152</u>	<u>\$ 286</u>

The Company anticipates that substantially all of the accrued liabilities will be paid in fiscal 2004.

**6. Bank Credit Agreement**

On October 29, 2002, the Company entered into a \$90 million secured revolving credit facility expiring on October 31, 2005. The credit agreement contains various covenants including, among others, covenants restricting the Company and its subsidiaries with respect to the incurrence of indebtedness, the creation of liens, the making of certain investments and loans, the payment of dividends, and the ability to enter into certain transactions with affiliates. In addition, the credit agreement requires the Company to maintain certain interest coverage, net worth and leverage ratios and places certain restrictions on capital expenditures. Interest due under the credit agreement is payable at a rate based upon the London Interbank Offered Rate (LIBOR) plus 2.75% per annum. As of September 30, 2003, the Company was in compliance with all covenants. At September 30, 2003, there was no debt outstanding under this agreement and the borrowing base amounted to \$44.7 million.

**7. Senior Notes**

The following is the detail of Senior Notes (in thousands):

	<u>September 30, 2003</u>	<u>March 31, 2003</u>
6 7/8% Senior Notes	\$ 94,829	\$ 94,809
11% Senior Notes	235,307	223,433
	<u>\$ 330,136</u>	<u>\$ 318,242</u>



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Changes in exchange rates had a significant impact on the reported balance of the 11% Senior Notes as of September 30, 2003 since the notes are denominated in Euros. Using the exchange rates in effect at March 31, 2003, the 11% Senior Notes as of September 30, 2003 would have been the same as reported at March 31, 2003. There were no principal payments on the 11% Senior Notes during the six months ended September 30, 2003.

**8. Guarantees, including indirect guarantees of indebtedness of others**

The Company has issued a \$1.2 million standby letter of credit maturing on April 25, 2005 to guarantee third party debt. In the event that certain obligors default on their payment obligations that are subject to the Company's standby letters of credit, the Company would be required to repay such obligations. If the obligors default on their payment obligations, the Company has recourse provisions that would enable it to recover fixed assets with an estimated net fair value of approximately \$1.2 million.

**9. Consolidated Statement of Comprehensive Income/(Loss)**

Other comprehensive loss includes foreign currency translation adjustments that are not adjusted for income taxes as they relate to indefinite investments in non-U.S. subsidiaries. Following is the consolidated statement of comprehensive income/(loss) for the three and six months ended September 30, 2003 and 2002 (in thousands):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2003	2002	2003	2002
Net income	\$6,683	\$ 6,530	\$ 7,201	\$ 1,178
Other comprehensive loss:				
Foreign currency translation	2,082	(9,447)	11,375	(9,337)
Comprehensive income/(loss)	\$8,765	\$(2,917)	\$18,576	\$(8,159)

**10. Earnings Per Share**

The following table sets forth the computation of basic and diluted earnings per share for the three and six months ended September 30, 2003 and 2002 (in thousands, except per share data):

	Three Months Ended September 30,		Six Months Ended September 30,	
	2003	2002	2003	2002
<b>Numerator:</b>				
Net income	\$ 6,683	\$ 6,530	\$ 7,201	\$ 1,178
<b>Denominator:</b>				
Weighted average common shares outstanding	24,905	24,557	24,814	24,550
Effect of dilutive securities-employee stock options	389	224	378	285
Weighted average common shares and dilutive securities outstanding	25,294	24,781	25,192	24,835
<b>Basic earnings per share</b>	<b>\$ 0.27</b>	<b>\$ 0.27</b>	<b>\$ 0.29</b>	<b>\$ 0.05</b>

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<b>Diluted earnings per share</b>	\$ 0.26	\$ 0.26	\$ 0.29	\$ 0.05
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For the three and six months ended September 30, 2003, options to purchase approximately 0.5 and 0.7 million shares of common stock with exercise prices at a range of \$17.34 to \$38.38 per share and \$16.50 to \$38.38, respectively, were not included in the calculation of diluted net loss per share because the options' exercise price was greater than the average market price of the common shares. For the three and six months ended September 30, 2002, options to purchase approximately 1.5 million shares of common stock with exercise prices at a range of \$9.26 to \$38.38 were not included in the calculation of diluted net loss per share because the options' exercise price was greater than the average market price of the common shares.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion of the Company's financial condition and results of operations should be read in conjunction with the Company's consolidated financial statements and notes thereto included elsewhere herein. This discussion contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may be materially different from the results we discuss in the forward-looking statements. For more information, refer to Information Relating to Forward-Looking Statements below.

### ***Overview***

We are a leading global designer, manufacturer and distributor of a broad range of plastic and glass eyeglass lenses and hold a strong manufacturing and technology position in the growing plastic lens segment of the global spectacle lens market. We have sales offices in 28 countries worldwide and operate in most major regions of the world. Our business is organized into three primary markets: North America, Europe and Rest of World (consisting primarily of Australia, Asia and South America). For the six months ended September 30, 2003, we generated approximately 43% of our net sales from North America, 39% from Europe and 18% from Rest of World. We believe that we hold a top three market position in terms of volume of plastic eyeglass lenses sold in each major region where we operate, including North America, Europe and Rest of World. We focus our efforts on products with advanced design characteristics, lens coatings and treatments and thin and light weight materials.

We market our spectacle lens products globally under the brands SOLA and American Optical (AO) and distribute them globally through four primary channels: (1) direct to national and international retail chains, (2) direct to independently-owned retail outlets, (3) independent processing laboratories, and (4) managed care organizations in the United States.

### ***Results of Operations***

*Three months ended September 30, 2003 compared to three months ended September 30, 2002*

#### ***Net Sales***

Our net sales were \$158.7 million in the three months ended September 30, 2003 compared to net sales of \$138.5 million in the same period for the prior year, an increase of \$20.2 million or 14.6%. Using constant exchange rates and on a comparable basis, total net sales increased 7.7%, with North America, Europe and Rest of World increasing 10.2%, 6.1% and 5.6%, respectively. The increase in all regions was driven primarily by increased sales of value-added products, particularly polycarbonate and photochromic products. Net sales performance by region was as follows:

North America increased by \$6.4 million or 10.3%;

Europe increased by \$9.8 million or 19.3%; and

Rest of World increased by \$4.0 million or 15.6%.

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The following table presents the reconciliation of constant currency results to as reported results (in millions except percentage data):

Region	Net sales, as reported for the	Constant Currency Adjustment	Adjusted net sales for the	Net sales, as reported for the	Percent increase
	three months ended September 30, 2002		three months ended September 30, 2002	three months ended September 30, 2003	
North America	\$ 62.2	\$	\$ 62.2	\$ 68.6	10.2%
Europe	50.6	6.3	56.9	60.4	6.1%
Rest of World	25.7	2.4	28.1	29.7	5.6%
<b>Total</b>	<b>\$ 138.5</b>	<b>\$ 8.7</b>	<b>\$ 147.2</b>	<b>\$ 158.7</b>	<b>7.7%</b>

Company management believes that constant currency sales growth provides a better representation of true operating results because changes in currency rates are beyond management's control and can cause reported results to fluctuate significantly.

**Gross Profit and Gross Margin**

Our gross profit totaled \$62.7 million for the three months ended September 30, 2003 compared to \$56.2 million for the same period in the prior year, an increase of \$6.5 million or 11.6%. Gross profit as a percentage of net sales, or gross margin, decreased to 39.5% for the three months ended September 30, 2003 from 40.6% in the same period in the prior year. The change in gross margin is considered normal and routinely occurs within the business.

**Operating Expenses**

Our operating expenses in the three months ended September 30, 2003 totaled \$42.0 million compared to operating expenses of \$41.2 million for the same period in the prior year. Operating expenses for the three months ended September 30, 2003 and 2002 as a percentage of net sales were 26.5% and 29.7%, respectively. Research and development expenses were \$2.4 million or 1.5% of net sales for the three months ended September 30, 2003 and were \$3.2 million or 2.3% of net sales for the three months ended September 30, 2002. The decrease of \$0.8 million is due in part to the effects of the transfer of research and development activities from Petaluma, California to Lonsdale, Australia in the third quarter of fiscal 2003. Selling and marketing expenses were \$28.3 million or 17.9% of net sales for the three months ended September 30, 2003 and were \$26.0 million or 18.8% of net sales for the three months ended September 30, 2002. The increase of \$2.3 million is primarily due to increased sales and marketing initiatives associated with the launch of several new products in fiscal 2004. Our general and administrative expenses were \$11.3 million or 7.1% of net sales for the three months ended September 30, 2003 and were \$12.0 million or 8.6% of net sales for the three months ended September 30, 2002. The decline of \$0.7 million in general and administrative expenses is due in part to a continued emphasis on management of expenses and cost containment.

**Table of Contents****Net Interest Expense and Foreign Currency Gain/(Loss)**

Our net interest expense totaled \$8.8 million for the three months ended September 30, 2003 compared to \$7.8 million for the three months ended September 30, 2002, an increase of \$1.0 million. Interest expense increased due to the strengthening of the Euro against the U.S. Dollar. For the three months ended September 30, 2003, we recorded a net foreign exchange loss of \$2.2 million compared to a foreign exchange gain of \$2.2 million for the same period in the prior year. Foreign exchange losses on external and intercompany notes of \$1.1 million were recorded in the three months ended September 30, 2003 due primarily to the weakening of the U.S. Dollar to the Euro. Conversely, foreign exchange gains on external and intercompany notes of \$1.5 million were recorded in the three months ended September 30, 2002 due primarily to the strengthening of the U.S. Dollar to the Euro.

**Provision for Income Taxes**

Our combined state, federal and foreign tax rate represents an effective tax rate projected for the full fiscal year 2004 of 29.0% compared to 30.0% used for the three months ended September 30, 2002. We have net deferred tax assets on our balance sheet as of September 30, 2003 amounting to \$49.2 million. The utilization of these deferred tax assets is dependent upon our ability to generate taxable income in the future.

**Results of Operations**

*Six months ended September 30, 2003 compared to six months ended September 30, 2002*

**Net Sales**

Our net sales were \$312.6 million in the six months ended September 30, 2003 compared to net sales of \$273.7 million in the same period for the prior year, an increase of \$38.9 million or 14.2%. Using constant exchange rates and on a comparable basis, net sales increased 6.5% with North America, Europe, and Rest of World increasing 10.7%, 4.9% and 0.6%, respectively. The increase in all regions was driven primarily by increased sales of value-added products, particularly polycarbonate and photochromic products. Net sales performance by region was as follows:

North America increased by \$13.1 million or 10.7%;

Europe increased by \$22.1 million or 22.2%; and

Rest of World increased by \$3.8 million or 7.4%.

The following table presents the reconciliation of constant currency results to as reported results (in millions except percentage data):

Region	Net sales, as reported for the six months ended September 30, 2002		Adjusted net sales for the six months ended September 30, 2002	Net sales, as reported for the six months ended September 30, 2003	
	Constant Currency Adjustment	Percent increase			
North America	\$ 122.5	\$	\$ 122.5	\$ 135.6	10.7%
Europe	99.5	16.4	115.9	121.6	4.9%
Rest of World	51.6	3.5	55.1	55.4	0.6%
<b>Total</b>	<b>\$ 273.7</b>	<b>\$ 19.8</b>	<b>\$ 293.5</b>	<b>\$ 312.6</b>	<b>6.5%</b>

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***Gross Profit and Gross Margin***

Our gross profit totaled \$125.0 million for the six months ended September 30, 2003 compared to \$111.6 million for the same period in the prior year, an increase of \$13.4 million or 12.1%. Gross profit as a percentage of net sales, or gross margin, decreased to 40.0% for the six months ended September 30, 2003 from 40.8% in the same period in the prior year. The change in gross margin is considered normal and routinely occurs within the business.

***Operating Expenses***

Our operating expenses in the six months ended September 30, 2003 totaled \$84.6 million compared to operating expenses of \$81.6 million for the same period in the prior year. Operating expenses for the six months ended September 30, 2003 and 2002 as a percentage of net sales were 27.1% and 29.8%, respectively. Research and development expenses were \$4.9 million or 1.6% of net sales for the six months ended September 30, 2003 and were \$6.5 million or 2.4% of net sales for the six months ended September 30, 2002. The decrease of \$1.6 million is due in part to the effects of the transfer of research and development activities from Petaluma, California to Lonsdale, Australia in the third quarter of fiscal 2003. Selling and marketing expenses were \$56.3 million or 18.0% of net sales for the six months ended September 30, 2003 and were \$52.0 million or 19.0% of net sales for the six months ended September 30, 2002. The increase of \$4.3 million is primarily due to increased sales and marketing initiatives associated with the launch of several new products in fiscal 2004. Our general and administrative expenses were \$23.4 million or 7.5% of net sales for the six months ended September 30, 2003 and were \$23.1 million or 8.4% of net sales for the six months ended September 30, 2002.

***Net Interest Expense and Foreign Currency Gain/(Loss)***

Our net interest expense totaled \$17.7 million for the six months ended September 30, 2003 compared to \$15.1 million for the six months ended September 30, 2002, an increase of \$2.6 million. The increase was primarily due to the impact of the Euro-U.S. Dollar exchange rates between periods. For the six months ended September 30, 2003, we recorded a net foreign exchange loss of \$12.2 million compared to a net foreign exchange loss of \$12.7 million for the same period in the prior year. Unrealized exchange losses on external and intercompany notes of \$11.0 million were recorded in the first six months of fiscal 2004 due primarily to the weakening of the U.S. Dollar to the Euro. Conversely, exchange losses on external and intercompany notes of \$19.2 million were recorded in the first six months of fiscal 2003 due primarily to the weakening of the U.S. Dollar to the Euro.

***Provision for Income Taxes***

Our combined state, federal and foreign tax rate represents an effective tax rate projected for the full fiscal year 2004 of 29.0% compared to 30.0% used for the six months ended September 30, 2002. We have net deferred tax assets on our balance sheet as of September 30, 2003 amounting to \$49.2 million. The utilization of these deferred tax assets is dependent upon our ability to generate taxable income in the future.

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***Liquidity and Capital Resources***

Our operating activities generated \$6.4 million in cash in the six months ended September 30, 2003 compared to \$4.1 million for the six months ended September 30, 2002. The increase resulted primarily from an improved operating performance in the six months ended September 30, 2003. Included in net income for the six month period ended September 30, 2003 was an unrealized \$7.8 million foreign currency loss on net long-term Euro-denominated debt (net of tax). Included in net income for the six months ended September 30, 2002 was a \$10.3 million foreign currency loss, of which \$12.2 million was unrealized, on net long-term Euro-denominated debt, foreign exchange contracts and Euro-denominated cash reserves (net of tax). Cash flow from operations was not impacted by the unrealized currency loss since it was non-cash in nature and, as a result, has been added back to net income for cash flow reporting purposes.

Our inventories as a percentage of annualized net sales for the six months ended September 30, 2003 and 2002 were 16.0% and 17.4%, respectively. Inventories at September 30, 2003 increased by \$10.3 million when compared to the previous year end at March 31, 2003. This increase was due to our decision to selectively increase global inventory balances to improve customer service levels. Accounts receivable as a percentage of annualized net sales for the six months ended September 30, 2003 decreased to 19.7% compared to 21.0% for the same period a year ago. Accounts receivable at September 30, 2003 increased by \$1.6 million when compared to the previous year end at March 31, 2003 due primarily to the impact of exchange rates.

During the six months ended September 30, 2003, net cash expended on investing activities amounted to \$7.9 million. This amount included \$0.9 million related to the acquisition of a prescription laboratory located in the U.S. The Company also incurred \$6.8 million of capital expenditures and \$2.1 million related to investments in molds. During the six months ended September 30, 2002, net cash expended on investing activities amounted to \$27.4 million. This amount included the acquisition of certain assets of two optical laboratories located in the U.S. and the acquisition of the net assets of a fabricator of polycarbonate molds and inserts and a Scandinavian distributor. The Company also incurred \$9.2 million of capital expenditures and \$1.2 million related to investments in molds. We anticipate capital expenditures, including molds, of approximately \$20-\$25 million in fiscal year 2004.

During the six months ended September 30, 2003, our net cash provided by financing activities amounted to \$1.0 million primarily as a result of \$2.8 million of proceeds received from exercise of stock options offset by \$1.8 million of net repayments on long-term debt. During the six months ended September 30, 2002, our net cash used by financing activities amounted to \$0.4 million primarily as a result of net repayments on long-term debt.

In addition to our outstanding 6 7/8% Senior Notes and 11% Senior Notes, our foreign subsidiaries maintain local credit facilities to provide credit for overdraft, working capital and some fixed asset investment purposes. As of September 30, 2003, the total borrowing capacity available to our foreign subsidiaries under these local facilities was approximately \$18.6 million, of which \$1.1 million had been utilized.

On October 29, 2002, we entered into a \$90 million secured revolving credit facility expiring on October 31, 2005. The credit agreement contains various covenants including, among others, covenants restricting us and our subsidiaries with respect to the incurrence of indebtedness, the creation of liens, the making of certain investments and loans, the payment of dividends, and the ability to enter into certain transactions with affiliates. In addition, the credit agreement requires us to maintain certain interest coverage, net worth and leverage ratios and places certain restrictions on capital expenditures. Interest due under the credit agreement is payable at a rate based upon the London Interbank Offered Rate (LIBOR) plus 2.75% per annum. As of September 30, 2003, we were in compliance with all covenants. At September 30, 2003, there was no debt outstanding under this agreement and the borrowing base amounted to \$44.7 million.

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We will continue to prudently manage operating expenses and further our efforts to lower unit costs and improve customer service levels. As a consequence, it is now anticipated that a charge for certain restructuring activities may be recorded commencing in the quarter ending December 31, 2003. It is further anticipated that this charge will not exceed \$20 million.

In order to continue our operations and meet our significant liquidity requirements, we must maintain profitable operations or obtain additional funds through equity or debt financing, bank financing, and other sources. We believe that our existing cash balances, credit facilities, internally generated funds and other potential financing alternatives will be sufficient to meet our capital, operating and debt service requirements for at least the next twelve months. If we are unable to generate adequate cash flow from sales of our products, we may need to seek additional sources of capital. There can be no assurance that we will be able to obtain additional debt or equity financing on terms acceptable to us, or at all. If adequate funds are not available, we could be required to delay development or commercialization of certain products, or reduce the marketing, customer support, or other resources devoted to product development. Accordingly, failure to obtain sufficient funds on acceptable terms when needed could have a material adverse effect on our business, results of operations and financial condition.

***Impact of Recently Issued Accounting Standards***

In November 2002, the Emerging Issues Task Force ( EITF ) reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of this standard had no material impact on our financial statements.

In January 2003, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 46 ( FIN 46 ), Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 applied for the first interim or annual period beginning after December 15, 2003. The adoption of this standard had no material impact on our financial statements.

In April 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities ( SFAS 149 ). SFAS 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts. SFAS 149 is effective for contracts entered into or modified after June 30, 2003. The adoption of this standard had no material impact on our financial statements.

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity ( SFAS 150 ). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The adoption of this standard had no material impact on our financial position, results of operations, or cash flows.

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### ***Currency Exchange Rates***

As a result of our worldwide operations, currency exchange rate fluctuations tend to affect our results of operations and financial position. The principal effect of currency exchange rates on our results of operations and financial position is the impact on our Euro-denominated debt and translation adjustments for subsidiaries where the local currency is the functional currency. Translation adjustments for functional local currencies have been recorded in other comprehensive income.

Certain countries have been determined to be hyperinflationary in fiscal 2002 as defined under the provisions of EITF Issue No. D-55, Determining a Highly Inflationary Economy under FASB Statement No. 52 and EITF Issue No. D-56, Accounting for a Change in Functional Currency and Deferred Taxes When an Economy Becomes Highly Inflationary. Accordingly, the results of our entities located in those countries are being accounted for in accordance with the provisions of these pronouncements.

Because a portion of our debt and associated interest is non-U.S. Dollar denominated, we may hedge against certain currency fluctuations by entering into currency swaps or forward contracts. As of September 30, 2003, we have several foreign exchange contracts outstanding to hedge portions of our accounts payable and accounts receivable exposure. We do not hold derivative financial instruments for speculative or trading purposes.

### ***Seasonality***

Our business is somewhat seasonal, with fiscal third quarter results generally weaker than the other three quarters as a result of lower sales during the holiday season, and fiscal fourth quarter results generally the strongest.

### ***Inflation***

Inflation continues to affect the cost of the goods and services that we use. The competitive environment in many markets limits our ability to recover higher costs through increased selling prices, and we are subject to price erosion in many of our standard product lines. We seek to mitigate the adverse effects of inflation through cost containment and productivity and manufacturing process improvements. For a description of the effects of inflation on our reported revenues and profits and the measures taken by us in response to inflationary conditions, see Currency Exchange Rates above.

### ***Information Relating to Forward-Looking Statements***

This quarterly report, including Management's Discussion and Analysis of Financial Condition and Results of Operations and Notes to Consolidated Financial Statements, contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, including statements regarding, among other items, the impact of inflation and future income tax rates and capital expenditures. These forward-looking statements reflect our current views with respect to future events and financial performance. The words may, will, could, would, believe, expect, anticipate and similar expressions identify forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of their dates. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Actual results could differ materially from the forward-looking statements as a result of known and unknown risks, uncertainties and other factors, including those described in the Risk Factors and Business-Environmental Matters sections of our Form 10-K for the fiscal year ended March 31, 2003.

**Table of Contents****Item 3. Quantitative and Qualitative Disclosures About Market Risk****Quantitative Disclosures**

We are exposed to market risks inherent in our operations, primarily related to interest rate risk and currency risk. These risks arise from transactions and operations entered into in the normal course of business.

*Interest Rate Risk.* We are subject to interest rate risk on our existing long-term debt and any future financing requirements. During the first six months of fiscal 2004, fixed rate debt consisted primarily of outstanding balances on Senior Notes.

The following table presents the future principal cash flows and weighted average interest rates expected on our existing long-term debt instruments. Fair values have been determined based on quoted market prices as of September 30, 2003:

	Expected Maturity Date (as of September 30, 2003)						Total	Fair Value
	Fiscal 2004	Fiscal 2005	Fiscal 2006	Fiscal 2007	Fiscal 2008	Thereafter		
(Dollars in thousands)								
Long-term debt:								
Fixed rate debt	\$2,722	\$1,755	\$1,782	\$1,222	\$330,397	\$ 362	\$338,240	\$369,471
Weighted average interest rate	5.77%	5.32%	5.35%	5.22%	9.78%	4.09%	9.69%	
Long-term debt:								
Variable rate debt	\$ 243	\$ 178	\$ 143	\$ 86	\$	\$	\$ 650	\$ 650
Weighted average interest rate	1.90%	1.56%	1.61%	1.59%			1.70%	

*Currency Rate Risk.* We are exposed to currency exchange rate fluctuations on our 11% Senior Notes, due 2008. Our subsidiaries primarily operate in foreign markets and predominantly have their local currencies as their functional currencies. These subsidiaries do not have third party borrowings in currencies other than their local currencies. Accordingly, there are no quantitative disclosures related to borrowings by our subsidiaries.

The following table presents the future principal cash flows and weighted average interest rates expected on the 11% Senior Notes, due 2008, as well as the contract amount and weighted average settlement price of the outstanding forward exchange contracts. Fair values have been determined based on quoted market prices as of September 30, 2003:



**Table of Contents****Expected Maturity Date (as of September 30, 2003)**

	<b>Fiscal 2004</b>	<b>Fiscal 2005</b>	<b>Fiscal 2006</b>	<b>Fiscal 2007</b>	<b>Fiscal 2008</b>	<b>Thereafter</b>	<b>Total</b>	<b>Fair Value</b>
(Dollars in thousands)								
Long-term debt:								
Fixed rate debt						\$ 235,307	\$ 235,307	\$ 262,368
Weighted average interest rate						11%	11%	
Forward exchange contracts:								
Contract amounts due								
October 2003	\$ 50,562						\$ 50,562	\$ 50,205
Contract amounts due								
November 2003	\$ 5,187						\$ 5,187	\$ 5,181
Contract amounts due								
December 2003	\$ 3,896						\$ 3,896	\$ 3,834
Contract amounts due								
January 2004	\$ 4,424						\$ 4,424	\$ 4,385
Contract amounts due								
February 2004	\$ 4,011						\$ 4,011	\$ 4,031
Contract amounts due								
March 2004	\$ 3,829						\$ 3,829	\$ 3,817
Weighted average settlement price	1.095						1.095	

**Qualitative Disclosures**

*Interest Rate Risk.* Our primary interest rate risk exposures relate to:

Our ability to pay or refinance long-term borrowings at maturity at market rates;

The impact of interest rate movements on our ability to meet interest expense requirements and financial covenants; and

The impact of interest rate movements on our ability to obtain adequate financing to fund future operations or business acquisitions.

We manage interest rate risk on our outstanding long-term borrowings through the use of fixed rate debt. While we cannot predict our ability to refinance existing debt, or the impact interest rate movements might have on existing debt, we evaluate our financial position on an ongoing basis. Borrowings on our credit line are interest rate sensitive, since the interest rate charged by our bank varies with changes in the LIBOR rate. We believe, however, that we are currently not subject to material interest rate risk. Because the majority of our debt is fixed rate in nature, an increase of 10% in interest rates would not materially increase our interest expense for the next 12 months.

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*Currency Rate Risk.* Our primary currency rate risk exposures relate to:

Our global operations, whereby approximately 58% of our revenues are derived from operations outside the United States, denominated in currencies other than the U.S. Dollar;

The ability of our operations to satisfy cash flow requirements of predominantly Euro and U.S. Dollar denominated long-term debt without the need to repatriate earnings and profits, which are denominated in currencies other than the Euro and U.S. Dollar;

Our investments in foreign subsidiaries being primarily directly from the U.S. parent, resulting in U.S. Dollar investments in foreign currency functional companies; and

The location of our operating subsidiaries in a number of countries that have experienced exchange rate changes against the U.S. Dollar, such as Brazil, Mexico, Venezuela, certain Asian countries, and countries located within the European Union.

We manage our currency rate risks through a variety of measures. In certain limited instances, subsidiaries, after obtaining approval from our head office, will enter into forward exchange contracts in connection with inter-company purchases and sales of products. These contracts do not extend longer than one year and are immaterial to the overall operations of the group. We do not hold derivative financial instruments for speculative or trading purposes. Although currency fluctuations are currently not a material risk to our operating results, we will continue to monitor our exposure to currency fluctuations and when appropriate, use financial hedging techniques to minimize the effect of these fluctuations in the future. We cannot assure you that exchange rate fluctuations will not harm our business. Subsidiaries operating in high inflation environments protect margins by methods that include increasing prices monthly at a rate appropriate to cover anticipated inflation, compounding interest charges on sales invoices daily and holding cash balances in U.S. Dollar denominated accounts where possible. We disclose constant exchange rate net sales performances in the aggregate, as well as by region, in Management's Discussion and Analysis of Financial Condition and Results of Operations. For more information, see "Currency Exchange Rates" above.

**Item 4. Controls and Procedures**

As of September 30, 2003, management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures, pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be disclosed in the reports the company files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

In connection with the evaluation by management, including our Chief Executive Officer and Chief Financial Officer, of our internal control over financial reporting, pursuant to Exchange Act Rule 13a-15(d), no changes during the quarter ended September 30, 2003 were identified that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

Item 1. Legal Proceedings

Not applicable

Item 2. Changes in Securities and Use of Proceeds

Not applicable

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## Item 3. Defaults upon Senior Securities

Not applicable

## Item 4. Submission of Matters to a Vote of Security Holders

The following matter was submitted to a vote of the security holders at our Annual Meeting of Stockholders on July 24, 2003:

Election of Directors. Votes as follows:

	<b>Total Vote for Each Director</b>	<b>Total Vote Withheld from Each Director</b>
Jeremy C. Bishop	21,889,337	478,840
Maurice J. Cunniffe	14,555,018	7,813,159
Douglas D. Danforth	21,830,346	537,831
Neil E. Leach	21,890,537	477,640
Robert A. Muh	21,880,537	487,640
Jackson L. Schultz	21,832,146	536,031

There were no abstentions or broker non-votes.

## Item 5. Other Information

Not applicable

## Item 6. Exhibits and Reports on Form 8-K

## (a) Exhibits

<b>Exhibit No.</b>	<b>Description</b>	<b>Reference</b>
3.1	Amended and Restated Certificate of Incorporation of the Company	Filed as Exhibit 3.1 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1995 and incorporated herein by reference (File No. 1-13606)
3.2	Amended and Restated By-Laws of the Company	Filed as Exhibit 3 to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 1998 and incorporated herein by reference (File No. 1-13606)
4.1	Rights Agreement dated as of August 27, 1998 between SOLA International Inc. and Bank Boston N.A	Filed as Exhibit 1 to the Company's Form 8-A dated August 27, 1998 and incorporated herein by reference (File No. 1-13606)

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Exhibit No.	Description	Reference
4.2	Indenture by and between the Company and State Street Bank and Trust Company of California, N.A., as Trustee, with respect to the 6 7/8% Notes due 2008	Filed as Exhibit 10.21 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 1998 and incorporated herein by reference (File No. 1-13606)
4.3	Officers' Certificate Related to Terms of Senior Notes	Filed as Exhibit 99.1 to the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1998 and incorporated herein by reference (File No. 1-13606)
4.4	Indenture dated as of April 17, 2001 by and between the Company and The Bank of New York, as Trustee, with respect to the 11% Notes due 2008	Filed as Exhibit 4.4 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2001 and incorporated herein by reference
4.5	Registration Rights Agreement dated as of April 17, 2001 by and among the Company and UBS AG acting through its business group UBS Warburg, as Initial Purchaser, with respect to the 11% Notes due 2008	Filed as Exhibit 4.5 to the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2001 and incorporated herein by reference
31.1	Rule 13a-14(a) Certification	
32.1	Section 1350 Certification	

## (b) Reports on Form 8-K

On August 6, 2003, we filed a Form 8-K containing as exhibit 99.1 our press release dated August 6, 2003. This press release contained our earnings information for the first quarter of fiscal 2004.

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**SIGNATURE**

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: October 29, 2003

SOLA International Inc.  
(Registrant)

By: /s/ Ronald F. Dutt

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Ronald F. Dutt  
Executive Vice President and  
Chief Financial Officer

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**Exhibit Index**

<b>Exhibit Number</b>	<b>Description</b>
31.1	Rule 13a-14(a) Certification
32.1	Section 1350 Certification