AMERICAN APPAREL, INC
Form 10-Q
May 09, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 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 March 31, 2013
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 No. 001-32697

American Apparel, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	20-3200601 (I.R.S. Employer Identification No.)
747 Warehouse Street, Los Angeles, California (Address of Principal Executive Offices)	90021 (Zip Code)

Registrant's Telephone Number, Including area code: (213) 488-0226

Indicate by checkmark 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of “large accelerated filer” and “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	o	Accelerated filer	o
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	x

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.

The number of shares of the registrant's common stock issued and outstanding as of May 1, 2013 was approximately 110,643,198 and 107,763,103.

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Unless the context requires otherwise, all references in this report to the “Company,” “Registrant”, “we,” “our,” and “us” refer American Apparel, Inc., a Delaware corporation, together with its wholly owned subsidiary, American Apparel (USA), LLC, and its other direct and indirect subsidiaries.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, including the documents incorporated by reference herein, contains forward-looking statements within the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995. All statements in this Quarterly Report on Form 10-Q other than statements of historical fact are “forward-looking statements” for purposes of these provisions. Statements that include the use of terminology such as “may,” “will,” “expects,” “believes,” “plans,” “estimates,” “potential,” or “continue,” or the negative thereof or other and similar expressions are forward-looking statements. In addition, in some cases, you can identify forward-looking statements by words or phrases such as “trend,” “potential,” “opportunity,” “believe,” “comfortable,” “expect,” “anticipate,” “current,” “intention,” “es “position,” “assume,” “outlook,” “continue,” “remain,” “maintain,” “sustain,” “seek,” “achieve,” and similar expressions. Any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, our goals, strategies, focuses and plans and other characterizations of future events or circumstances, including statements expressing general expectations or beliefs, whether positive or negative, about future operating results or the development of our products and any statement of assumptions underlying any of the foregoing are forward-looking statements. Forward-looking statements in this report may include, without limitation, statements about:

- future financial condition and operating results;
- our ability to remain in compliance with financial covenants under our financing arrangements;
- our liquidity and projected cash flows;
- our plan to make continued investments in advertising and marketing;
- our growth, expansion and acquisition prospects and strategies, the success of such strategies, and the benefits we believe can be derived from such strategies;
- the outcome of investigations, enforcement actions and litigation matters, including exposure, which could exceed expectations;
- our intellectual property rights and those of others, including actual or potential competitors, our personnel, consultants, and collaborators;
- operations outside the United States;
- trends in raw material costs and other costs both in the industry, and specific to the Company;
- the supply of raw materials and the effects of supply shortages on our financial condition, and results of operations;
- economic and political conditions;
- overall industry and market performance;
- the impact of accounting pronouncements;
- our ability to improve manufacturing efficiency at our production facilities;
- management's goals and plans for future operations; and
- other assumptions described in this Quarterly Report on Form 10-Q underlying or relating to any forward-looking statements.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements, which are qualified in their entirety by this cautionary statement. Forward-looking statements are subject to numerous assumptions, events, risks, uncertainties and other factors, including those that may be outside of our control and that change over time. As a result, actual results and/or the timing of events could differ materially from those expressed in or implied by the forward-looking statements and future results could differ materially from historical performance. Such assumptions, events, risks, uncertainties and other factors include, among others, those described under Part II, Item IA and elsewhere in this report and in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 (filed with the United States Securities and Exchange Commission (the “SEC”) on March 5, 2013) as well as in other reports and documents we file with the SEC and include, without limitation, the following:

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- our ability to generate or obtain from external sources sufficient liquidity for operations and debt service;
- changes in the level of consumer spending or preferences or demand for our products;
- our financial condition, operating results and projected cash flows;
- disruptions in the global financial markets;
- consequences of our significant indebtedness, including our relationship with our lenders, our ability to comply with our debt agreements and generate cash flow to service our debt;
- our ability to maintain compliance with the exchange rules of the NYSE MKT, LLC;
- the highly competitive and evolving nature of our business in the U.S. and internationally;
- our ability to effectively carry out and manage our strategy, including growth and expansion both in the U.S. and internationally;
- loss of U.S. import protections or changes in duties, tariffs and quotas, and other risks associated with international business;
- intensity of competition, both domestic and foreign;
- technological changes in manufacturing, wholesaling, or retailing;
- risks that our suppliers or distributors may not timely produce or deliver our products;
- loss or reduction in sales to our wholesale or retail customers or financial nonperformance by our wholesale customers;
- the adoption of new accounting standards or changes in interpretations of accounting principles;
- our ability to pass on the added cost of raw materials to our wholesale and retail customers;
- the availability of store locations at appropriate terms and our ability to identify and negotiate new store locations effectively and to open new stores and expand internationally;
- our ability to attract customers to our stores;
- seasonality and fluctuations in comparable store sales and margins;
- our ability to successfully implement our strategic, operating, financial and personnel initiatives;
- our ability to maintain the value and image of our brand and protect our intellectual property rights;
- changes in the cost of materials and labor, including increases in the price of raw materials in the global market;
- our ability to improve manufacturing efficiency at our production facilities;
- location of our facilities in the same geographic area;
- risks associated with our foreign operations and foreign supply sources, such as disruption of markets, changes in import and export laws, currency restrictions, and currency exchange rate fluctuations;
- adverse changes in our credit ratings and any related impact on financial costs and structure;
- continued compliance with U.S. and foreign government regulations, legislation, and regulatory environments, including environmental, immigration, labor, and occupational health and safety laws and regulations;
- the risk that information technology systems changes and the transition to our new distribution center in La Mirada, California (as described herein) may disrupt our supply chain or operations and our ability to upgrade our information technology infrastructure and other risks associated with the systems that operate our online retail operations;
- litigation and other inquiries and investigations, including the risks that we or our officers will not be successful in defending any proceedings, lawsuits, disputes, claims or audits, and that exposure could exceed expectations or insurance coverages;
- our ability to effectively manage inventory levels;
- changes in key personnel, our ability to hire and retain key personnel, and our relationship with our employees;
- general economic conditions, including increases in interest rates, geopolitical events, other regulatory changes and inflation or deflation;
- disruptions due to severe weather or climate change; and
- disruptions due to earthquakes, flooding, tsunamis or other natural disasters.

All forward-looking statements included in this document are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statements.

PART I-FINANCIAL INFORMATION
Item 1. Financial Statements (unaudited)
American Apparel, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(Amounts and shares in thousands, except per share amounts)
(unaudited)

	March 31, 2013	December 31, 2012*
ASSETS		
CURRENT ASSETS		
Cash	$5,688	$12,853
Trade accounts receivable, net of allowances of $1,915 and $2,085 at March 31, 2013 and December 31, 2012, respectively	23,042	22,962
Prepaid expenses and other current assets	9,295	9,589
Inventories, net	177,351	174,229
Restricted cash	2,678	3,733
Income taxes receivable and prepaid income taxes	259	530
Deferred income taxes, net of valuation allowance of $12,760 at both March 31, 2013 and December 31, 2012	426	494
Total current assets	218,739	224,390
PROPERTY AND EQUIPMENT, net	68,173	67,778
DEFERRED INCOME TAXES, net of valuation allowance of $64,818 at both March 31, 2013 and December 31, 2012	1,209	1,261
RESTRICTED CASH	1,629	—
OTHER ASSETS, net	37,201	34,783
TOTAL ASSETS	$326,951	$328,212
LIABILITIES AND STOCKHOLDERS' (DEFICIT) EQUITY		
CURRENT LIABILITIES		
Cash overdraft	$1,340	$—
Revolving credit facilities and current portion of long-term debt	68,116	60,556
Accounts payable	41,784	38,160
Accrued expenses and other current liabilities	40,675	41,516
Fair value of warrant liability	40,886	17,241
Income taxes payable	2,257	2,137
Deferred income tax liability, current	257	296
Current portion of capital lease obligations	1,737	1,703
Total current liabilities	197,052	161,609
LONG-TERM DEBT, net of unamortized discount of $25,899 and $27,929 at March 31, 2013 and December 31, 2012, respectively	118,358	110,012
CAPITAL LEASE OBLIGATIONS, net of current portion	2,632	2,844
DEFERRED TAX LIABILITY	247	262
DEFERRED RENT, net of current portion	20,115	20,706
OTHER LONG-TERM LIABILITIES	10,932	10,695
TOTAL LIABILITIES	349,336	306,128
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' (DEFICIT) EQUITY		
Preferred stock, $0.0001 par value per share, authorized 1,000 shares; none issued	—	—
Common stock, $0.0001 par value per share, authorized 230,000 shares; 110,533 shares issued and 107,624 shares outstanding at March 31, 2013 and 110,111 shares issued and	11	11

107,181 shares outstanding at December 31, 2012		
Additional paid-in capital	180,627	177,081
Accumulated other comprehensive loss	(4,229)	(2,725)
Accumulated deficit	(196,637)	(150,126)
Less: Treasury stock, 304 shares at cost	(2,157)	(2,157)
TOTAL STOCKHOLDERS' (DEFICIT) EQUITY	(22,385)	22,084
TOTAL LIABILITIES AND STOCKHOLDERS' (DEFICIT) EQUITY	$326,951	$328,212

* Condensed from audited financial statements.

See accompanying notes to condensed consolidated financial statements.

American Apparel, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations and Comprehensive Loss
(Amounts and shares in thousands, except per share amounts)
(unaudited)

	Three Months Ended March 31,	
	2013	2012
Net sales	$138,060	$132,660
Cost of sales	65,192	62,604
Gross profit	72,868	70,056
Selling expenses	55,463	54,929
General and administrative expenses (including related party charges of $217 and $321 for the three months ended March 31, 2013 and 2012, respectively)	27,804	24,922
Retail store impairment	78	—
Loss from operations	(10,477)	(9,795)
Interest expense	11,214	9,553
Foreign currency transaction loss (gain)	713	(950)
Unrealized loss on change in fair value of warrants	23,645	651
Gain on extinguishment of debt	—	(11,588)
Other (income) expense	(5)	128
Loss before income taxes	(46,044)	(7,589)
Income tax provision	467	302
Net loss	$(46,511)	$(7,891)
Basic and diluted loss per share	$(0.42)	$(0.07)
Weighted average basic and diluted shares outstanding	109,918	105,707
Net loss (from above)	$(46,511)	$(7,891)
Other comprehensive (loss) income item:		
Foreign currency translation, net of tax	(1,504)	331
Other comprehensive (loss) income, net of tax	(1,504)	331
Comprehensive loss	$(48,015)	$(7,560)

See accompanying notes to condensed consolidated financial statements.

American Apparel, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Amounts in thousands)
(unaudited)

	Three Months Ended March 31, 2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$137,654	$133,818
Cash paid to suppliers, employees and others	(139,649)	(141,724)
Income taxes refunded	9	745
Interest paid	(4,040)	(1,376)
Other	18	(109)
Net cash used in operating activities	(6,008)	(8,646)
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(7,354)	(3,690)
Proceeds from sale of fixed assets	12	34
Restricted cash	(622)	(6,802)
Net cash used in investing activities	(7,964)	(10,458)
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash overdraft	1,340	114
Repayments of expired revolving credit facilities, net	—	(45,121)
Borrowings under current revolving credit facilities, net	7,624	29,997
(Repayments) borrowings of term loans and notes payable	(3)	35,785
Payments of debt issuance costs	(1,678)	(4,696)
Repayments of capital lease obligations	(176)	(271)
Net cash provided by financing activities	7,107	15,808
EFFECT OF FOREIGN EXCHANGE RATE ON CASH	(300)	305
NET DECREASE IN CASH	(7,165)	(2,991)
CASH, beginning of period	12,853	10,293
CASH, end of period	$5,688	$7,302

See accompanying notes to condensed consolidated financial statements.

American Apparel, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows (continued)
(Amounts in thousands)
(unaudited)

	Three Months Ended March 31,	
	2013	2012
RECONCILIATION OF NET LOSS TO NET CASH USED IN OPERATING ACTIVITIES		
Net loss	$(46,511)	$(7,891)
Depreciation and amortization of property and equipment, and other assets	6,031	5,852
Retail store impairment	78	—
Loss on disposal of property and equipment	13	18
Share-based compensation expense	3,547	1,842
Unrealized loss on change in fair value of warrants	23,645	651
Amortization of debt discount and deferred financing costs	2,610	2,943
Gain on extinguishment of debt	—	(11,588)
Accrued interest paid-in-kind	4,564	5,234
Foreign currency transaction loss (gain)	713	(950)
Allowance for inventory shrinkage and obsolescence	254	128
Bad debt expense	139	41
Deferred income taxes	—	(7)
Deferred rent	(448)	(8)
Changes in cash due to changes in operating assets and liabilities:		
Trade accounts receivables	(545)	1,117
Inventories	(4,811)	(93)
Prepaid expenses and other current assets	220	(1,668)
Other assets	(1,825)	(583)
Accounts payable	3,999	2,333
Accrued expenses and other liabilities	1,859	(7,043)
Income taxes receivable / payable	460	1,026
Net cash used in operating activities	$(6,008)	$(8,646)
NON-CASH INVESTING AND FINANCING ACTIVITIES		
Property and equipment acquired, and included in accounts payable	$3,433	$782

See accompanying notes to condensed consolidated financial statements.

American Apparel, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
For the Three Months Ended March 31, 2013 and 2012
(Amounts and shares in thousands, except per share amounts)
(unaudited)

Note 1. Organization and Business

American Apparel, Inc. and its subsidiaries (collectively the "Company") is a vertically-integrated manufacturer, distributor, and retailer of branded fashion basic apparel products and designs, manufactures and sells clothing and accessories for women, men, children and babies. The Company sells its products through the wholesale distribution channel supplying t-shirts and other casual wear to distributors and screen printers, as well as direct to customers through its retail stores located in the United States, and internationally. In addition, the Company operates an online retail e-commerce website. At March 31, 2013, the Company operated a total of 249 retail stores in 20 countries: the United States, Canada and 18 other countries.

Liquidity and Management's Plan

On April 4, 2013, the Company closed a private offering of $206,000 aggregate principal amount of its 13% Senior Secured Notes due 2020 at 97% of par and also entered into a new $35,000 asset-backed revolving credit facility with Capital One Leverage Finance Corp. maturing on April 4, 2018, subject to a January 15, 2018 maturity under certain circumstances.

The Company used the net proceeds from the offering of the notes, together with borrowings under the new credit facility to repay and terminate its credit agreement with Crystal Financial LLC and its loan agreement with Lion Capital LLP. The notes and the new credit facility are senior secured obligations of the Company and are guaranteed, on a senior secured basis, by the Company's domestic restricted subsidiaries, subject to some exceptions (see Notes 6 and 7).

As of March 31, 2013, the Company had approximately $5,688 in cash, $2,417 of availability for additional borrowings under the Crystal Credit Agreement and Bank of Montreal Credit Agreement (as defined in Note 6). Additionally, the Company had outstanding $37,594 on the $50,000 revolving credit facility under the Crystal Credit Agreement, $30,000 of term loans outstanding under the Crystal Credit Agreement, $477 outstanding on a C$11,000 (Canadian dollars) revolving credit facility under the Bank of Montreal Credit Agreement, and $118,039 (including paid-in-kind interest of $22,798 and net of discount $25,899) of term loans outstanding under the Lion Loan Agreement (as defined in Note 7).

The Company believes that it has sufficient financing commitments to meet funding requirements for the next twelve months.

The Company continues to executing its plan, which was commenced in late 2010, to improve its operating performance and financial position. Among other things, in 2013, the Company intends to complete the installation of RFID tracking systems in all of its stores, complete the opening of its new distribution facility in La Mirada, California, continue with expansion of its selling square footage in its stores, continue with its inventory productivity improvement program, further reduce operating expenses, and improve online sales performance with the implementation of the Oracle ATG back-end online system for international store fronts. In addition, the Company continues to seek improvements in store labor productivity and workers' compensation exposure. The Company expects to fully transition its distribution operations into the new distribution facility in the first half of 2013. The Company believes that the new distribution center will contribute to processing efficiencies and effectiveness and will reduce operating expenses and cost of sales. The Company continues to develop other initiatives intended to either increase sales, reduce costs or improve liquidity.

There can be no assurance that plans to improve operating performance and financial position will be successful.

Note 2. Summary of Significant Accounting Policies

Principles of Consolidation and Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of American Apparel, Inc. and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated upon consolidation. Certain reclassifications have been made to the prior year's condensed consolidated financial statements and related footnotes to conform them to the 2013 presentation.

The accompanying unaudited condensed consolidated financial statements of the Company and its wholly owned subsidiaries have been prepared by the Company, in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information, and are presented in accordance with the requirements of Form 10-Q and Rule 10-01 of Regulation S-X, and have not been audited. Accordingly, these unaudited condensed consolidated financial statements do not include all of the information and notes required by GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and notes thereto for the fiscal year ended December 31, 2012 included in the Company's Annual Report on Form 10-K. In the opinion of management, the interim unaudited condensed consolidated financial statements included herein contain all adjustments, including normal recurring adjustments, considered necessary to present fairly the Company's financial position, the results of operations and cash flows for the periods presented.

The operating results and cash flows of the interim periods presented herein are not necessarily indicative of the results to be expected for any other interim period or the full year.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets, and liabilities at the date of the financial statements, and reported amounts of revenues, and expenses during the reporting period. Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets, and liabilities that are not readily apparent from other sources. The most complex and subjective estimates include: self-insured liabilities, inventory valuation and obsolescence; valuation and recoverability of long-lived assets, including the values assigned to goodwill, property and equipment; fair value calculations, including derivative liabilities such as the Lion warrants; contingencies, including accruals for the outcome of current litigation; and income taxes as well as other taxes and governmental assessments, including uncertain income tax positions and recoverability of deferred income taxes.

On a regular basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience, and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results could differ from those estimates.

Restricted Cash

Restricted cash primarily represents cash collateral on standby letters of credit and certain other obligations. The standby letters of credit are predominantly used as collateral for the Company's workers' compensation program. See Note 14.

Concentration of Credit Risk

Financial instruments, which potentially subject the Company to credit risk consist primarily of cash (the amounts of which may, at times, exceed Federal Deposit Insurance Corporation limits on insurable amounts) and trade accounts receivable (including credit card receivables), relating substantially to the Company’s U.S. Wholesale segment. The Company mitigates its risk by investing through major financial institutions. The Company had approximately $4,495 and $8,265 held in foreign banks at March 31, 2013 and December 31, 2012, respectively.

The Company mitigates its risks related to trade receivables by performing on-going credit evaluations of its customers and adjusts credit limits based upon payment history and the customer’s current credit worthiness, as determined by the review of their current credit information. The Company also maintains an insurance policy for certain customers based on a customer’s credit rating and established limits. Collections and payments from customers are continuously monitored. One customer in the Company's U.S. Wholesale segment accounted for 20.6% and 15.1% of the Company’s total accounts receivables as of March 31, 2013 and December 31, 2012, respectively. The Company maintains an allowance for doubtful accounts, which is based upon historical experience and specific customer collection issues that have been identified. While bad debt expenses have historically been within expectations and allowances established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

Fair Value Measurements

The Company’s financial instruments are primarily composed of cash, restricted cash, accounts receivable (including credit card receivables), accounts payable, revolving credit borrowings, its term loan and warrants. The fair value of cash, restricted cash, accounts receivable, accounts payable and variable rate borrowings closely approximates their carrying value due to their short maturities and variable rates. The fair value of the fixed-rate term note is estimated using a discounted cash flow analysis.

The valuation techniques utilized are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect internal market assumptions. These

two types of inputs create the following fair value hierarchy:
Level 1 – Quoted prices in active markets for identical assets or liabilities.
Level 2 – Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the related asset or liabilities.
Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of assets or liabilities.

The Company utilizes observable market inputs (quoted market prices) when measuring fair value whenever possible. For fair value measurements categorized within Level 3 of the fair value hierarchy, the Company's accounting and finance department, who report to the Chief Financial Officer, determine its valuation policies and procedures. The development and determination of the unobservable inputs for Level 3 fair value measurements and fair value calculations are the responsibility of the Company's accounting and finance department and are approved by the Chief Financial Officer.

As of March 31, 2013, there were no transfers in or out of Level 3 from other levels.

The fair value of the fixed rate term note is estimated using a projected discounted cash flow analysis based on unobservable inputs including interest payments, principal payments and discount rate, and is classified within Level 3 of the valuation hierarchy. An increase or decrease in the discount rate assumption, in isolation, can significantly decrease or increase the fair value of the term note. See Note 8.

The fair value of each warrant is estimated using either a Monte Carlo simulation model or the Binomial Lattice option valuation model. Significant observable and unobservable inputs include stock price, exercise price, annual risk free rate, term, and expected volatility, and are classified within Level 3 of the valuation hierarchy. An increase or decrease in volatility, in isolation, can significantly increase or decrease the fair value of the warrant. See Notes 8 and 11.

The fair value of indefinite-lived assets, which consists exclusively of goodwill, is measured in connection with the Company’s annual goodwill impairment test. The fair value of the reporting unit to which goodwill has been assigned, is determined using a projected discounted cash flow analysis based on unobservable inputs including gross profit, discount rate, working capital requirements, capital expenditures, depreciation and terminal value assumptions, and are classified within Level 3 of the valuation hierarchy. An increase or decrease in the discount rate assumption and/or the terminal value assumption, in isolation, can have a significant effect on the fair value of the reporting unit.

Retail stores that have indicators of impairment and whose carrying value of assets are greater than their related projected undiscounted future cash flows, are measured for impairment by comparing the fair value of the assets against their carrying value. Fair value of the assets is estimated using a projected discounted cash flow analysis based on unobservable inputs including gross profit and discount rate, and is classified within Level 3 of the valuation hierarchy. An increase or decrease in the discount rate assumption, in isolation, can significantly decrease or increase the fair value of the assets, which would have an effect on the impairment recorded.

Income Taxes

The Company recognizes deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The Company estimates the degree to which tax assets and credit carryforwards will result in a benefit based on expected profitability by tax jurisdiction. A valuation allowance for such tax assets and loss carryforwards is provided when it is determined that such amounts will more likely than not go unrealized. If it becomes more likely than not that a tax asset will be realized, any related valuation allowance of such assets would be reversed.

During the three months ended March 31, 2013 and 2012, the Company incurred losses from operations. Based upon these results, and trends in the Company's performance projected through 2013, it is more likely than not that the Company will not realize any benefit from the deferred tax assets recorded by the Company in previous periods. The Company did not record income tax benefits in the condensed consolidated financial statements for the three months ended March 31, 2013 and 2012 as the Company determined that it was more likely than not that sufficient taxable income in the future will not be generated in the respective jurisdictions to realize the deferred income tax assets.

Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In addition, the Company operates within multiple taxing jurisdictions and is subject to audit in these jurisdictions. In management's opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary.

The Company's foreign domiciled subsidiaries are subject to foreign income taxes on earnings in their respective jurisdictions. The Company elected to have their foreign subsidiaries, except for its subsidiaries in Brazil, Canada, China, Spain, Italy, Ireland and Korea, consolidated in the Company's U.S. federal income tax return. The Company will generally be eligible to receive tax credits on its U.S. federal income tax return for most of the foreign taxes paid by the Company's entities included in the United States Federal income tax return.

The Company accounts for uncertain tax positions in accordance with ASC 740-“Income Taxes”, and gross unrecognized tax benefits at March 31, 2013 and December 31, 2012 are included in current liabilities in the accompanying condensed consolidated balance sheets. The Company accrues interest and penalties on unrecognized tax benefits as components of the income tax provision in the accompanying condensed consolidated statements of operations.

Accounting Standards Updates

Recently issued accounting standards updates are not expected to have a material effect on the Company's condensed consolidated financial statements.

Subsequent Events

The Company has evaluated events that occurred subsequent to March 31, 2013 and through the date the financial statements were available to be issued. Other than those events disclosed in these notes to these financial statements, including the financing transactions that closed on April 4, 2013, management concluded that no additional subsequent events required disclosure in these financial statements.

Note 3. Inventories

The components of inventories are as follows:

	March 31, 2013	December 31, 2012
Raw materials	$22,261	$22,301
Work in process	2,999	2,197
Finished goods	154,984	152,384
	180,244	176,882
Less reserve for inventory shrinkage and obsolescence	(2,893)	(2,653)
Total, net of reserves	$177,351	$174,229

Inventories are stated at the lower of cost or market. Cost is primarily determined on the first-in, first-out (FIFO) method. The cost elements of inventories include materials, labor and overhead. For the three months ended March 31, 2013 and 2012, no one supplier provided more than 10% of the Company’s raw material purchases.

The Company identifies potentially excess and slow-moving inventories by evaluating turn rates, inventory levels and other factors and provides reserves for lower of cost or market reserves for such identified excess and slow-moving inventories. At March 31, 2013 and December 31, 2012, the Company had a lower of cost or market reserve for excess and slow-moving inventories of $1,921 and $2,140, respectively.

The Company establishes a reserve for inventory shrinkage for each of its retail locations and its warehouse. The reserve is based on the historical results of physical inventory cycle counts. The Company had a reserve for inventory shrinkage in the amount of $972 and $513 at March 31, 2013 and December 31, 2012, respectively.

Note 4. Property and Equipment

Depreciation and amortization expense relating to property and equipment (including capitalized leases) is recorded in cost of sales and operating expenses. For the three months ended March 31, 2013 and 2012, depreciation and amortization expense was $6,031 and $5,852, respectively.

The Company evaluates its retail stores for indicators of impairment, specifically related to under-performance or operating losses relative to expected historical or projected future operating results. Stores whose carrying value of assets are greater than their related projected undiscounted future cash flows, are measured for impairment by comparing the fair value of the assets against their carrying value. The fair value of the assets is estimated using a projected discounted cash flow analysis (Level 3 in the fair value hierarchy). The key assumptions used in the estimates of projected cash flows were sales, gross margins, and payroll costs. These forecasts were based on historical trends and take into account recent developments, as well as the Company's plans and intentions.

For the three months ended March 31, 2013, the Company recorded impairment charges relating to retail stores leasehold improvements of $78. The Company determined that no impairment charges for the three months ended March 31, 2012 were required.

Note 5. Accrued Expenses and Other Current Liabilities

The components of accrued expenses and other current liabilities are as follows:

	March 31, 2013	December 31, 2012
Compensation, bonuses and related taxes	$9,778	$11,524
Workers' compensation and other self-insurance reserves (Note 14)	5,609	5,288
Sales, value and property taxes	3,752	4,751
Gift cards and store credits	5,070	5,964
Loss contingencies	752	752
Accrued vacation	1,522	1,055
Deferred revenue	414	590
Deferred rent	2,913	2,997
Other	10,865	8,595
Total accrued expenses	$40,675	$41,516

Note 6. Revolving Credit Facilities and Current Portion of Long-Term Debt

The following table presents revolving credit facilities and current portion of long-term debt:

	March 31, 2013	December 31, 2012
Revolving credit facility (Crystal), maturing March 2015 (a)	$37,594	$26,113
Term loan (Crystal), maturing March 2015 (a)	30,000	30,000
Revolving credit facility (Bank of Montreal), maturing December 2013	477	4,387
Current portion of long-term debt (Note 7)	45	56
Total revolving credit facilities and current portion of long-term debt	$68,116	$60,556

(a) All outstanding principal amounts and accrued and unpaid interest and fees under the Crystal revolving credit facility and term loan were repaid with the proceeds of the financing transactions that the Company closed on April 4, 2013.

The Company incurred interest charges of $11,214 and $9,553 for the three months ended March 31, 2013 and 2012, respectively, for all outstanding borrowings. The interest charges subject to capitalization for the three months ended March 31, 2013 and 2012 were not significant.

Revolving Credit Facility - Capital One

On April 4, 2013, the Company and its domestic subsidiaries replaced the credit facility with Crystal with a new $35,000 asset-based revolving facility with Capital One Leverage Finance Corp. ("Capital One" and the credit facility, the "Capital One Credit Facility").

The Capital One Credit Facility permits the Company to increase commitments to up to $50,000 in the aggregate, subject to obtaining additional commitments from other third parties and other customary conditions. The Capital One Credit Facility matures on April 4, 2018, subject to a January 15, 2018 maturity if excess availability is less than $15,000 at the time of notice to Capital One of a determination by the Company that an Applicable High Yield Discount Obligation ("AHYDO") redemption will be required pursuant to Section 3.01(e) of the indenture governing the Senior Secured Notes due 2020 (the "Notes"). Borrowings under the Capital One Credit Facility bear interest equal to LIBOR plus 3.5% or the bank's prime rate plus 2.5% (at the Company's option) and are subject to maintenance of specified borrowing base requirements and covenants. The Capital One Credit Facility is secured by a lien on substantially all of the assets of the Company's domestic subsidiaries and equity interests in certain of the Company's foreign subsidiaries, subject to some exceptions.

The Company is required to maintain a minimum fixed charge coverage ratio of not less than 1.00 to 1.00 and is also required to not exceed certain maximum leverage ratio thresholds, both determined as at the end of each fiscal quarter. Additionally, the Company's domestic subsidiaries are subject to an annual limitation of certain specified capital expenditure amounts as determined at the end of each fiscal year.

Among other provisions, the Capital One Credit Facility requires that the Company maintain a lockbox arrangement and contains certain subjective acceleration clauses. In addition, Capital One may at its discretion, adjust the advance restriction and criteria for eligible inventory and accounts receivable. The Capital One Credit Facility contains cross-default provisions

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whereby an event of default under the Bank of Montreal Credit Agreement, under the indenture governing the Notes or other indebtedness, in each case of an amount greater than a specified threshold, would cause an event of default under the Capital One Credit Facility. If an event of default occurs and is continuing under the Capital One Credit Facility, Capital One may, among other things, terminate the obligations of the lenders to make loans, and the obligation of the letter of credit issuer to make letter of credit extensions, and require the Company to repay all outstanding amounts.

Revolving Credit Facility - Bank of Montreal

On December 29, 2012, the Company's wholly-owned subsidiaries, American Apparel Canada Wholesale, Inc. and American Apparel Canada Retail Inc. (collectively, the “CI Companies”), entered into an amendment to their existing line of credit with Bank of Montreal (the "Bank of Montreal Credit Agreement") that extended the maturity of the agreement to December 31, 2013. The agreement provides for borrowings up to C$11,000 (Canadian dollars), bearing interest at 7.0% (the bank's prime rate at 3.0% as of March 31, 2013 plus 4.0% per annum payable monthly). This line of credit is secured by a lien on the CI Companies' accounts receivable, inventory and certain other tangible assets. Available borrowing capacity at March 31, 2013 was $656.

The Bank of Montreal Credit Agreement contains a fixed charge coverage ratio and restricts the Company's Canadian subsidiaries from entering into operating leases above a specified threshold. Additionally, the Bank of Montreal Credit Agreement imposes a minimum excess availability covenant, which requires the Company's Canadian subsidiaries to maintain at all times minimum excess availability of 5.0% of the revolving credit commitment under the facility.

The Bank of Montreal Credit Agreement also contains cross-default provisions with the Crystal Credit Agreement and the Lion Loan Agreement, whereby an event of default occurring under either of those credit agreements would have caused an event of default under the Bank of Montreal Credit Agreement. The Bank of Montreal Credit Agreement also contains cross-default provisions with the Capital-One Credit Facility and the Notes, whereby an event of default occurring thereunder would cause an event of default under the Bank of Montreal Credit Agreement.

As of March 31, 2013, the Company was in compliance with all required financial covenants of the Bank of Montreal Credit Agreement.

Revolving Credit Facility and Term Loan - Crystal

As of March 31, 2013, the Company was party to a credit agreement, maturing on March 13, 2015, with Crystal Financial LLC ("Crystal" and the "Crystal Credit Agreement", respectively), and other lenders party thereto, that provided the Company with a $80,000 senior credit facility. The Crystal Credit Agreement calls for the $80,000 to be allocated between an asset-based revolving credit facility of $50,000 and term loan of $30,000. As of March 31, 2013, the Company had $780 of outstanding letters of credit secured against the Crystal Credit Agreement. The amount available for additional borrowings on March 31, 2013 was $1,761.

As of March 31, 2013, the interest under the Crystal Credit Agreement was 9.78% (the 90-day LIBOR at 0.28% plus 9.5%) and included an unused facility fee ranging from 0.375% to 1.0% on the unused portion of the revolving credit facility, payable monthly. Additionally, the interest rate with respect to the brand name portion of the outstanding principal amount was 19.28% (the 90-day LIBOR at 0.28% plus 19.0%).

On April 4, 2013, the Company replaced its existing revolving credit facility and term loan with Crystal with a new $35,000 asset-based revolving credit agreement with Capital One. In connection with the termination of the Crystal Credit Agreement, the Company paid an early termination fee of $2,400. The difference between the net carrying amount of the Crystal loans of $60,533 (which includes the outstanding balance, accrued but unpaid interest, and unamortized financing cost immediately prior to the date of the extinguishment) and the cash paid to Crystal of $66,468, which includes the early termination fee, will be recorded as a $5,935 loss on early extinguishment of debt in the statement of operations for the quarter ended June 30, 2013.

Note 7. Long-Term Debt
Long-term debt consists of the following:

	March 31, 2013	December 31, 2012
Long-term debt with Lion (a)	$118,039	$109,680
Other	364	388
Total long-term debt	118,403	110,068
Current portion of debt	(45)	(56)
Long-term debt, net of current portion	$118,358	$110,012

(a) Including accrued interest paid-in-kind of $22,798 and $16,469 and net of unamortized discount of $25,899 and $27,929 at March 31, 2013 and December 31, 2012, respectively. All amounts owed to Lion were repaid with the proceeds of the financing transactions that the Company closed on April 4, 2013.

Senior Secured Notes due 2020

On April 4, 2013, the Company issued $206,000 aggregate principal amount of its 13% Senior Secured Notes due 2020 (the "Notes"). The Notes will mature on April 15, 2020. The Notes were issued at 97% of par value and will bear interest at a rate of 13% per annum. Interest on the Notes is payable semi-annually, in arrears, on April 15 and October 15 of each year, beginning on October 15, 2013.

A "special interest trigger event" will be deemed to have occurred under the indenture governing the Notes if the Company's net leverage ratio for the year ended December 31, 2013 is greater than 4.50 to 1.00. If a special interest trigger event occurs, interest on the Notes will accrue at the rate of 15% per annum, retroactive to April 4, 2013, with the interest in excess of 13% per annum payable (i) in the case of any interest payment date prior to April 15, 2018, by adding such excess interest to the principal amount of the Notes on the interest payment date, and (ii) for any interest payment date on or after April 15, 2018, in cash.

On or after April 15, 2017, the Company may, at its option, redeem some or all of the Notes at a premium decreasing ratably to zero as specified in the indenture, plus accrued and unpaid interest to, but not including, the redemption date. Prior to April 15, 2017, the Company may, at its option, redeem up to 35% of the aggregate principal amount of the Notes with the net cash proceeds of certain equity offerings at a redemption price of 113% of the aggregate principal amount of the redeemed notes plus accrued and unpaid interest to, but not including, the redemption date. In addition, at any time prior to April 15, 2017 the Company may, at its option, redeem some or all of the Notes by paying a "make whole" premium, plus accrued and unpaid interest to, but not including, the redemption date. If the Company experiences certain change of control events, the holders of the Notes will have the right to require the Company to purchase all or a portion of the Notes at a price in cash equal to 101% of the principal amount of such Notes, plus accrued and unpaid interest to, but not including, the date of purchase. In addition, the Company is required to use the net proceeds of certain asset sales, if not used for specified purposes, to purchase some of the Notes at 100% of the principal amount, plus accrued and unpaid interest to, but not including, the date of purchase. On each interest payment date after April 4, 2018, the Company will be required to redeem, for cash, a portion of each Note then outstanding equal to the amount necessary to prevent such Note from being treated as an “applicable high yield discount obligation” within the meaning of the Internal Revenue Code. The redemption price will be 100% of the principal amount plus accrued and unpaid interest thereon on the date of redemption.

The Notes are guaranteed, jointly and severally, on a senior secured basis by the Company's existing and future domestic subsidiaries. The Notes and the related guarantees are secured by a first-priority lien on the Company's and its domestic subsidiaries' assets (other than the Credit Facility Priority Collateral, as defined below, subject to some exceptions and permitted liens). The Notes and the related guarantees also are secured by a second-priority lien on all of Company's and its domestic subsidiaries' accounts receivable, inventory, cash, and certain other assets (collectively, the "Credit Facility Priority Collateral"), subject to certain exceptions and permitted liens. The Notes and the guarantees, respectively, rank equal in right of payment with the Company's and its domestic subsidiaries' senior indebtedness, including indebtedness under the Capital One Credit Facility, before giving effect to collateral arrangements.

The Notes impose certain limitations on the ability of the Company and its domestic subsidiaries to, among other things, and subject to a number of important qualifications and exceptions, incur additional indebtedness or issue disqualified capital stock or preferred stock (with respect to restricted subsidiaries), grant liens, make payments in respect of their capital stock or certain indebtedness, enter into transactions with affiliates, create dividend or other payment restrictions affecting subsidiaries, merge or consolidate with any other person, sell, assign, transfer, lease, convey or otherwise dispose of all or substantially all of its assets or adopt a plan of liquidation. The Company must annually report to the trustee on compliance with such limitations.

The Notes also contain cross-default provisions whereby a payment default or acceleration of any indebtedness in an aggregate amount greater than a specified threshold would cause an event of default with respect to the Notes.

In connection with the issuance of the Notes, the Company entered into a Registration Rights Agreement under which the Company has agreed to, among other things, conduct a registered exchange offer with respect to the Notes. If the Company fails to fulfill its obligations under the Registration Rights Agreement in a timely manner, it may be required to pay additional interest on the Notes.

Lion Loan Agreement

On March 31, 2013, the Company had a loan agreement, maturing on December 31, 2015, with Lion Capital LLP ("Lion" and the "Lion Loan Agreement", respectively) and the other lenders party thereto. The term loan, as amended, bore interest at a range between 15% and 18% per annum, depending on certain financial covenants, payable quarterly in arrears. For the three months ended March 31, 2013, the interest rate was 18% per annum on an outstanding amount of $118,039, net of discount and including paid-in-kind interest. Amortization of debt discount included in interest expense was $2,030 and $2,193 for the three months ended March 31, 2013 and 2012, respectively. The Company's obligations under the Lion Loan Agreement were secured by a second lien on substantially all of the assets of the Company and was subordinated to the Crystal Credit Agreement.

The Company repaid and terminated its outstanding obligations under the Lion Loan Agreement with a portion of the proceeds of the financing transactions closed by the Company on April 4, 2013. There were no early termination penalties associated with the termination of the Lion Loan Agreement. The difference between the net carrying amount of the Lion debt of $117,926 (which includes the principal, accrued but unpaid interest, unamortized discount and unamortized financing cost immediately prior to the date of extinguishment) and the cash paid to Lion of $144,177 will be recorded in its statement of operations for the quarter ended June 30, 2013 as a $26,251 loss on the early extinguishment of this debt.

Note 8. Fair Value of Financial Instruments

The fair value of the Company's financial instruments are measured on a recurring basis. The carrying amount reported in the accompanying condensed consolidated balance sheets for cash, accounts receivable (including credit card receivables), accounts payable and accrued expenses approximates fair value because of the short-term maturity of those instruments. The carrying amount for borrowings from Crystal and the Bank of Montreal approximates fair value because of the variable market interest rate charged to the Company for these borrowings. The fair value of the term loan with Lion was estimated using a discounted cash flow analysis and a yield rate that was estimated using yield rates for publicly traded debt instruments of comparable companies with similar features. The fair value of each warrant was estimated using either a Monte Carlo simulation model or the Binomial Lattice option valuation model. The Company did not have any assets or liabilities categorized as Level 1 or 2 as of March 31, 2013.

The following table presents carrying amounts and fair values of the Company's financial instruments as of March 31, 2013:

	Carrying Amount		Fair Value
Liabilities			
Long-term debt with Lion, net of discount of $25,899 and including interest paid-in-kind of $22,798	$118,039		$113,080
Lion Warrant	—	(a)	40,524
SOF Warrant	—	(a)	362
	$118,039		$153,966

(a) No cost is associated with these liabilities (see Note 11)

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The following table summarizes the activity of Level 3 inputs measured on a recurring basis:

Fair Value Measurements of Common Stock Warrants using Significant Unobservable Inputs (Level 3)	Three Months Ended March 31,	
	2013	2012
Balance at January 1,	$ 17,241	$ 9,633
Adjustment resulting from change in value recognized in earnings (a)	23,645	651
Gain on extinguishment of debt	—	3,482
Balance at March 31,	$ 40,886	$