PEETS COFFEE & TEA INC
Form 10-Q
November 12, 2003

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 September 28, 2003

OR

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

Commission file number 000-32233

PEET'S COFFEE & TEA, INC.
(Exact Name of Registrant as Specified in Its Charter)

Washington	91-0863396
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

1400 Park Avenue
Emeryville, California 94608-3520
(Address of Principal Executive Offices) (Zip Code)

(510) 594-2100
(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 Securities Exchange Act Rule 12b-2). Yes [X] No [ ]

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

Common Stock, no par value	12,915,270
(Class)	(Outstanding at November 4, 2003)

PEET'S COFFEE & TEA, INC.

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PEET'S COFFEE & TEA, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED, IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	SEPTEMBER 28, 2003	DECE
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,175	$
Accounts receivable	2,831	
Income tax receivable	300	
Inventories	13,058	
Prepaid expenses and other	3,710	
Total current assets	47,074	
Property and equipment, net	31,860	
Intangible and other assets, net	2,962	
Long-term U.S. Government and Agency securities	24,956	

Total assets	$ 106,852	$
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,963	$
Accrued compensation and benefits	3,875	
Other accrued liabilities	5,240	
Current portion of long-term borrowings	444	
Total current liabilities	14,522	
Long-term borrowings, less current portion	90	
Deferred income taxes	32	
Deferred lease credits	828	
Total liabilities	15,472	
Shareholders' equity:		
Common stock, no par value; authorized 50,000,000 shares; issued and outstanding: 12,900,000 and 12,103,000 shares	86,621	
Accumulated other comprehensive income, net of tax	36	
Retained earnings	4,723	
Total shareholders' equity	91,380	
Total liabilities and shareholders' equity	$ 106,852	$

See notes to condensed consolidated financial statements.

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PEET'S COFFEE & TEA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED, IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	THIRTEEN WEEKS ENDED		
	SEPT. 28, 2003	SEPT. 29, 2002	S
Net revenue	$ 28,833	$ 25,366	$
Operating expenses:			
Cost of sales and related occupancy expenses	13,308	11,651	
Operating expenses	9,426	8,182	
Marketing and advertising expenses	958	1,161	
General and administrative expenses	4,860	1,403	
Depreciation and amortization expenses	1,228	1,160	
Total operating costs and expenses	29,780	23,557	

Income (loss) from operations	(947)	1,809
Investment income, net	499	220
Income (loss) before income taxes	(448)	2,029
Income tax provision (benefit)	(125)	750
Net income (loss)	$ (323)	$ 1,279
Net income (loss) per share:		
Basic	$ (0.03)	$ 0.11
Diluted	$ (0.03)	$ 0.10
Shares used in calculation of net income (loss) per share:		
Basic	12,778	11,992
Diluted	12,778	12,673

See notes to condensed consolidated financial statements.

PEET'S COFFEE & TEA, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED, IN THOUSANDS)

Cash flows from operating activities:	
Net income	$
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation and amortization	
Amortization of investment interest purchased	
Amortization of stock based compensation, including tax benefit of stock options exercised	
Deferred income taxes	
Reclassification of hedging losses (gains) from OCI	
Ineffective portion of hedges	
Gain on disposition of assets	
Gain on sale of long-term investments	
Changes in other assets and liabilities:	
Receivables	
Inventories	
Prepaid expenses and other current assets	
Other assets	
Accounts payable, accrued liabilities and other liabilities	
Net cash provided by operating activities	
Cash flows from investing activities:	
Purchases of property and equipment	
Other	

Purchases of long term U.S. government & agency securities	
Proceeds from sale of long-term U.S. government & agency securities	
Net cash used in investing activities	
Cash flows from financing activities:	
Repayments of debt	
Net proceeds from issuance of common stock	
Net cash provided by financing activities	
Change in cash and cash equivalents	
Cash and cash equivalents, beginning of period	
Cash and cash equivalents, end of period	$

See notes to condensed consolidated financial statements.

PEET'S COFFEE & TEA, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
UNAUDITED

1. BASIS OF PRESENTATION

The accompanying condensed consolidated financial statements of Peet's Coffee & Tea, Inc. and its subsidiaries (collectively, the "Company") for the thirteen and thirty-nine weeks ended September 28, 2003 and September 29, 2002 are unaudited and, in the opinion of management, contain all adjustments (consisting only of normal recurring items) necessary to present fairly the financial position and results of operations for such periods. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended December 29, 2002. The results of operations for the thirteen and thirty-nine weeks ended September 28, 2003 are not necessarily indicative of the results expected for the full year.

The balance sheet information as of December 29, 2002, presented herein, has been derived from the audited consolidated financial statements of the Company included in the Annual Report on Form 10-K for the year ended December 29, 2002.

Certain reclassifications of prior year balances have been made to conform to the current presentation.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

STOCK BASED COMPENSATION

The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principle Board No. 25 ("APB No. 25"), "Accounting for Stock Issued to Employees." Accordingly, no compensation cost has been recognized for the stock option awards granted at fair market value. Through 2001, the Company granted options at 85% of fair value and recorded compensation expense equal to the intrinsic value over the vesting period. Statement of Financial Accounting Standards No. 123 ("SFAS No.

123"), "Accounting for Stock-Based Compensation", requires the disclosure of pro forma net income (loss) and earnings (loss) per share as if the Company had adopted the fair value method. Had compensation cost for the Company's stock option plans and employee stock purchase plan been determined based on the fair value at the grant date consistent with the provisions of SFAS No. 123, the Company's net income (loss) would have been reduced to the pro forma amounts indicated below (in thousands):

	THIRTEEN WEEKS ENDED		THIRTY-
	SEPT. 28, 2003	SEPT. 29, 2002	SEPT. 28,
Net income (loss) - as reported	($323)	$ 1,279	$ 2
Stock-based employee compensation included in reported net income (loss) , net of tax. . .	70	41	
Stock-based compensation expense determined under fair value based method, net of tax. .	(784)	(939)	(2
Net income (loss) - pro forma	($1,037)	$ 381	(
Basic net income (loss) per share - as reported .	($0.03)	$ 0.11	$
Basic net income (loss) per share - pro forma . .	($0.08)	$ 0.03	($
Diluted net income (loss) per share - as reported	($0.03)	$ 0.10	$
Diluted net income (loss) per share - pro forma .	($0.08)	$ 0.03	($

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The Company uses the Black-Scholes option-pricing model for determining the fair value of options, which requires the input of certain estimates that may affect the determination of fair value. The existing model may not necessarily provide a reliable single measure of the value of its stock options. Management will continue to evaluate alternative methodologies that may more appropriately reflect pro forma compensation expense.

The fair value of each option grant and ESPP award is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	OPTIONS GRANTED FOR THE PERIOD ENDED	
	SEPT. 28, 2003	SEPT. 29, 2002
Expected dividend rate .	0.00%	0.00%
Expected volatility		
- Options	49.81%	68.10%
- ESPP awards	49.81%	68.10%
Risk free interest rate		
- Options	3.41%	3.79%
- ESPP awards	1.26%	1.87%
Expected lives (years)		
- Options	5.00	5.00
- ESPP awards	0.50	0.50

COMPREHENSIVE INCOME

For the thirteen week period ended September 28, 2003 and September 29, 2002, comprehensive income (loss) was ($520,000) and $1,475,000, respectively. Comprehensive income was $2,269,000 and $3,054,000 for the thirty-nine weeks ended September 28, 2003 and September 29, 2002, respectively. Comprehensive income (loss) consists of net income or loss, the effect of accounting for hedges under SFAS No. 133, and net unrealized gains on investments. See Notes 4 and 5.

NET INCOME (LOSS) PER SHARE

The following table summarizes the differences between basic weighted average shares outstanding and diluted weighted average shares outstanding used to compute diluted net income (loss) per share (in thousands):

	THIRTEEN WEEKS ENDED		THIRTY-NINE WEE	
	SEPT. 28, 2003	SEPT. 29, 2002	SEPT. 28, 2003	SEPT
Basic weighted average shares outstanding .	12,778	11,992	12,472	
Incremental shares from assumed exercise of stock options		681	683	
Diluted weighted average shares outstanding	12,778	12,673	13,155	

For the thirteen weeks ended September 28, 2003, basic net loss equals diluted net loss per share as the effect of options would be antidilutive in a loss period.

The number of incremental shares from the assumed exercise of stock options was calculated applying the treasury stock method.

Options with an exercise price greater than the average market price of common shares were 0 and 1,075,431 for the thirteen week period ended September 28, 2003 and September 29, 2002, respectively, and 98,663 and 474,979 for the thirty-nine week period ended September 28, 2003 and September 29, 2002, respectively, and were not included in the computation of diluted earnings per share.

3. BORROWINGS

The Company maintains a credit facility with General Electric Capital Corporation that expires in September 2005 and provides for a revolving line of credit of up to $15,000,000, including the issuance of up to $3,000,000 in letters of credit. Total availability under the revolving line of credit is determined by subtracting the Company's funded debt from its trailing twelve month earnings before interest, taxes, depreciation and amortization, or EBITDA, multiplied by 2.5. As of September 28, 2003, there was no outstanding balance and $14,410,000 was available under the Company's revolving line of credit.

Borrowings under the credit facility are secured by a lien on substantially all of the Company's assets. The credit facility contains covenants restricting the Company's ability to make capital expenditures, incur additional indebtedness and lease obligations, open retail stores, make restricted

payments, merge into or with other companies and sell all or substantially all of its assets and requiring the Company to meet certain financial tests.

4. HEDGING ACTIVITIES

The Company is exposed to price risk related to price-to-be-fixed coffee purchase commitments and anticipated coffee purchases. The Company uses coffee futures and options to manage price increase and designates these derivative instruments as cash-flow hedges of its price-to-be-fixed coffee purchase commitments and anticipated coffee purchases. These derivative instruments qualify for hedge accounting under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." The Company does not hold or issue derivative instruments for trading purposes.

As of September 28, 2003, there were no open futures contracts. Other comprehensive loss related to hedging activities for prior quarters, net of tax, was $6,000 as of September 28, 2003, all of which is expected to be reclassified into cost of goods sold over the next 12 months as the related inventory is sold. For the period ended September 29, 2002, the other comprehensive loss related to hedging activities, net of tax was $25,000. During the thirteen and thirty-nine weeks ended September 28, 2003, respectively, $5,000 (net of $3,000 tax) of coffee futures gains and $21,000 (net of $15,000 tax) of coffee futures gains, included in other comprehensive income (loss), were reclassified into cost of goods sold. For the same prior year periods, $31,000 (net of $21,000 tax) and $387,000 (net of $257,000), of coffee futures losses included in other comprehensive loss were reclassified into cost of goods sold.

5. INVESTMENTS

The Company invests in U.S. government and agency securities. At September 28, 2003, the Company maintained long-term investments classified as available for sale of $24,956,000. The long-term investments are comprised of United States Treasury notes and bonds and federal agency notes and bonds that mature within five years. Gross unrealized holding gains of $48,000 ($30,000 net of tax) at September 28, 2003 were attributable to long-term investments.

During the thirteen and thirty-nine weeks ended September 28, 2003, the Company sold securities for net proceeds of $23,056,000 and $30,758,000, respectively, and realized gains of $284,000 and $296,000 computed using the specific identification method. For the thirteen and thirty-nine weeks ended September 28, 2003, net unrealized losses of $194,000 (net of $130,000 tax) and net unrealized losses of $188,000 (net of $125,000 tax), respectively, were recorded in other comprehensive income. For the prior year thirteen and thirty-nine week periods ended September 29, 2002, there was a net unrealized gain of $217,000.

6. SEGMENT INFORMATION

The Company operates in two reportable segments: retail and specialty sales. Retail store operations consist of sales of whole bean coffee, beverages, tea and related products through Company-operated retail stores. Specialty sales consists of online and mail order sales of whole bean coffee shipped directly to the consumer and whole bean coffee sales through grocery, restaurant and foodservice and office coffee accounts.

The following table presents certain financial information for each segment. Segment income before taxes excludes unallocated marketing expenses and general and administrative expenses. Unallocated assets include cash, coffee inventory in the warehouse, corporate headquarter assets and intangibles and other assets.

	RETAIL	SPECIALTY SALES	UNALLOCATED	TOTAL
THIRTEEN WEEKS ENDED SEPTEMBER 28, 2003				
Net revenue	$20,706	$ 8,127		$ 28,833
Operating expenses	7,420	2,006		9,426
Depreciation and amortization	849	239	$ 140	1,228
Segment operating income (loss)	2,861	2,100	(5,908)	(947)
Investment income, net			499	499
Income (loss) before income taxes				(448)
Total assets	20,959	7,156	78,737	106,852
THIRTEEN WEEKS ENDED SEPTEMBER 29, 2002				
Net revenue	$18,702	$ 6,664		$ 25,366
Operating expenses	6,702	1,480		8,182
Depreciation and amortization	804	235	$ 121	1,160
Segment operating income (loss)	2,581	1,870	(2,642)	1,809
Investment income, net			220	220
Income before income taxes				2,029
Total assets	20,425	4,496	64,079	89,000
THIRTY-NINE WEEKS ENDED SEPTEMBER 28, 2003				
Net revenue	$61,794	$23,517		$ 85,311
Operating expenses	22,015	6,168		28,183
Depreciation and amortization	2,486	694	$ 367	3,547
Segment operating income (loss)	9,017	5,471	(11,283)	3,205
Investment income, net			972	972
Income before income taxes				4,177
Capital expenditures	4,839	1,354	1,786	7,979
THIRTY-NINE WEEKS ENDED SEPTEMBER 29, 2002				
Net revenue	$56,975	$17,736		$ 74,711
Operating expenses	20,172	3,928		24,100
Depreciation and amortization	2,396	659	$ 335	3,390
Segment operating income (loss)	8,156	4,557	(9,076)	3,637
Investment income, net			307	307
Income before income taxes				3,944
Capital expenditures	2,244	645	2,097	4,986

7. CONTINGENCIES

During the thirteen weeks ended September 28, 2003, the Company recorded a charge of $3.4 million to settle litigation and for severance. On February 25, 2003 and March 7, 2003, two lawsuits were filed against the Company entitled Brian Taraz, et al vs. Peet's Coffee & Tea, Inc., and Tracy Coffee, et al. vs. Peet's Coffee & Tea, Inc. Each was filed in Superior Court of the State of California, County of Orange, and sought class action certification. These suits were filed by one former and one current store manager alleging misclassification of employment position and sought damages, restitution, reclassification and attorneys' fees and costs. On October 27, 2003, the Company announced that it had reached an agreement in principle to settle the lawsuits to fully resolve all claims brought by the plaintiffs. The Company recorded a charge during the third quarter for the estimated payment of claims to eligible class members, attorneys' fees and costs, costs to a third-party claims administrator, as well as applicable employer payroll taxes, which is included in "General and administrative expenses" on the accompanying condensed consolidated statements of operations for the thirteen and thirty-nine weeks ended September 28, 2003. The settlement is subject to the court's final approval and the Company's right to terminate if more than 10% of the settlement

class opts out of the settlement.

In addition to the lawsuits described above, we may from time to time become involved in certain legal proceedings in the ordinary course of business. Currently, the Company is not party to any other legal proceedings that management believes would have a material adverse effect on the financial position or results of operations of the Company.

8. RECENT ACCOUNTING PRONOUNCEMENTS

During April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under Statement 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively. The adoption of SFAS No. 149 did not have a significant impact on our operating results or financial position.

During May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS No. 150 clarifies the accounting for certain financial instruments with characteristics of both liabilities and equity and requires that those instruments be classified as liabilities in statements of financial position. Previously, many of those financial instruments were classified as equity. SFAS No. 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 SFAS No. 150 did not have a significant impact on our operating results or financial position.

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

You should read the following discussion and analysis in conjunction with our financial statements and related notes included elsewhere in this report. Except for historical information, the discussion in this report contains certain forward-looking statements that involve risks and uncertainties. We have based these forward-looking statements on our current expectations and assumptions about future events. In some cases, you can identify forward-looking statements by terminology, such as "may," "will," "should," "could," "predict," "potential," "continue, "expect," "anticipate," "future," "intend," "plan," "believe," "estimate" and similar expressions (or the negative of such expressions). These statements are based on our current beliefs, expectations and assumptions and are subject to a number of risks and uncertainties. Actual future results and trends may differ materially depending on a variety of factors including but not limited to, coffee and other raw material prices and availability, successful execution of strategies and plans for expansion, competition, general economic conditions, economic or political instability related to recent or potential terrorist attacks, the popularity of specialty coffee due to consumer trends, labor relations, health factors or other issues, as well as other risk factors as described more fully in our Annual Report on Form 10-K for the year ended December 29, 2002. Forward-looking statements speak only as of the date of this report and we assume no obligation to update any forward-looking statements.

COMPANY OVERVIEW AND INDUSTRY OUTLOOK

Peet's is a specialty coffee roaster and marketer of branded fresh roasted whole bean coffee sold through multiple channels of distribution. Since the founding of our business in 1966, we have established a customer base and brand recognition in California. Our national expansion strategy is based on the sale of whole bean coffee through multiple channels of distribution. We are indifferent as to where our consumers purchase our coffees, and we believe that growth opportunities exist in all of these channels, which consists of retail stores, online and mailorder, grocery stores, restaurants and foodservice and

office coffee accounts.

We expect the specialty coffee industry to continue to grow. We believe that this growth will be fueled by continued consumer interest in high quality coffee and related products.

Our operations are vertically integrated. We purchase Arabica coffee beans from countries around the world, apply our artisan-roasting techniques and ship fresh coffee daily to customers within 24 hours of roasting. We believe that control of purchasing, roasting, packaging and distribution of our coffee allows us to maintain our commitment to freshness, is cost effective and enhances our margins and profit potential.

Our coffee and related items are sold through two segments as defined under Statement of Financial Accounting Standards No. 131 ("SFAS No. 131"), "Disclosures About Segment of Enterprise and Related Information." These segments are Company-operated retail outlets and specialty sales (consisting of online and mail order, grocery, food service, and office). We evaluate segment performance primarily based on revenue and segment operating income.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires the appropriate application of certain accounting policies, many of which require us to make estimates and assumptions about future events and their impact on amounts reported in our financial statements and related notes. Since future events and their impact cannot be determined with certainty, the actual results will inevitably differ from our estimates. Such differences could be material to our financial statements.

We believe our application of accounting policies, and the estimates inherently required therein, are reasonable. These accounting policies and estimates are constantly reevaluated, and adjustments are made when facts and circumstances dictate a change. Historically, we have found our application of accounting policies to be appropriate and actual results have not differed materially from those determined using necessary estimates.

Our accounting policies are more fully described in Note 2 in the "Notes to the Consolidated Financial Statements," included in our Annual Report on Form 10-K for the year ended December 29, 2002. We have identified the following critical accounting policies:

-Inventory. Raw materials consist primarily of green bean coffee. Finished goods consist primarily of roasted coffee, tea, accessory products, spices and packaged foods. All products are valued at the lower of cost or market using the first-in, first-out method, except green bean and roasted coffee, which is valued at the average cost. We continually evaluate the composition of our coffee related merchandise and mark down such inventory as needed. Our historical inventory write-offs have been immaterial.

-Intangibles and other assets. During 2002, we entered into a contractual agreement with Safeway Inc., a national grocery chain, to sell Peet's coffee through its grocery stores. We began shipping during the third quarter of 2002. The agreement included an upfront payment to Safeway Inc. that we recorded in intangibles and other assets and is being amortized as a reduction of revenue based upon estimated sales during the contract period.

-Long-lived assets. In evaluating the fair value and future benefits of long-lived assets, we perform an analysis of the anticipated undiscounted future net cash flows of the related long-lived asset and reduce their carrying value by the excess, if any, of the result of such calculation. We believe at this time that the long-lived assets' carrying values and useful lives continue to be appropriate.

-Accrued compensation. In March 2002, we modified our workers' compensation insurance policy to a high deductible insurance program with an overall program ceiling to minimize exposure. We began recording an estimated liability for self-insured portion of the workers' compensation claims in our condensed consolidated financial statements. The self-insurance liability is determined actuarially, based on claims paid, filed and reserved for, and projected using an industry loss development factor, as well as using historical experience ratings. Should a greater amount of claims occur compared to what is estimated or the medical costs increase beyond what was anticipated, the recorded liability may not be sufficient.

-Litigation settlement costs. In February and March 2003, two lawsuits were filed against the Company. One former and one current store manager alleging misclassification of employment position filed these two suits and sought class action certification. The suit also sought damages, restitution, reclassification, and attorneys' fees. In October 2003, the Company announced an agreement in principle to settle the lawsuits to fully resolve all claims brought by the plaintiffs without engaging in protracted litigation. As of September 28, 2003, we recorded a charge for the estimated payment of claims to eligible class members, attorneys' fees and costs, costs to a third-party claims administrator, as well as applicable payroll taxes. This accrual makes certain assumptions regarding the estimated liability, including but not limited to the percentage of class member that participate in the class, the degree to which eligible claimants participate, and associated fees and taxes.

-Hedge accounting. We use coffee futures and options to hedge price increases in price-to-be-fixed coffee purchase commitments and anticipated coffee purchases. These derivative instruments qualify for hedge accounting under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." Hedge accounting is permitted if the hedging relationship is expected to be highly effective. Effectiveness is determined by how closely the changes in the fair value of the derivative instrument offset the changes in the fair value of the hedged item. If the derivative is determined to qualify for hedge accounting, the effective portion of the change in the fair value of the derivative instrument is recorded in other comprehensive income and recognized in earnings when the related hedged item is sold. The ineffective portion of the change in the fair value of the derivative instrument is recorded directly to earnings. If these derivative instruments do not qualify for hedge accounting, we would have to record the changes in the fair value of the derivative instruments directly to earnings. As of September 28, 2003, we have no outstanding hedging contracts. See "Item 3. Quantitative and Qualitative Disclosures about Market Risk" and Note 4 in the "Notes to Condensed Consolidated Financial Statements," included elsewhere in this report.

We have also chosen certain accounting policies when options are available, including the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25 ("APB No. 25"), "Accounting for Stock Issued to Employees," to account for our stock option awards. These accounting policies are applied consistently for all years presented.

RESULTS OF OPERATIONS

The following discussion of results of operations should be read in conjunction with our financial statements and accompanying notes and other financial data included elsewhere in this report. The following table sets forth certain financial data for the periods indicated.

	THIRTEEN WEEKS ENDED		
	SEPT. 28, 2003	SEPT. 29, 2002	SEP
STATEMENT OF OPERATIONS DATA AS A PERCENT OF NET REVENUE:			
Net revenue.	100.0%	100.0%	
Cost of sales and related occupancy expenses	46.1	45.9	
Operating expenses	32.7	32.3	
Marketing and advertising expenses	3.3	4.6	
General and administrative expenses.	16.9	5.5	
Depreciation and amortization expenses	4.2	4.6	
Income (loss) from operations.	(3.2)	7.1	
Investment income, net	(1.7)	(0.9)	
Income (loss) before income taxes.	(1.5)	8.0	
Income tax provision (benefit)	(0.4)	3.0	
Net income (loss).	(1.1)%	5.0%	
PERCENT OF NET REVENUE BY BUSINESS SEGMENT:			
Retail stores.	71.8%	73.7%	
Specialty sales.	28.2	26.3	
PERCENT OF NET REVENUE BY BUSINESS CATEGORY:			
Whole bean coffee and related products	57.8%	59.4%	
Beverages and pastries	42.2	40.6	
OPERATING EXPENSES AS A PERCENT OF SEGMENT REVENUE:			
Retail stores.	35.8%	35.8%	
Specialty sales.	24.7	22.2	
PERCENT INCREASE (DECREASE) FROM PRIOR YEAR:			
Net revenue.	13.7%		
Retail stores	10.7		
Specialty sales	22.0		
Cost of sales and related occupancy expenses	14.2		
Operating expenses	15.2		
Marketing and advertising expenses	(17.5)		
General and administrative expenses.	246.4		
Depreciation and amortization expenses	5.9		
SELECTED OPERATING DATA:			
Number of retail stores in operation:			
Beginning of the period	69	60	
Store openings.	3	1	
End of period	72	61	

THIRTEEN WEEKS ENDED SEPTEMBER 28, 2003 COMPARED TO THIRTEEN WEEKS ENDED SEPTEMBER 29, 2002

NET REVENUE

Net revenue for the thirteen weeks ended September 28, 2003 increased versus the same prior year period primarily as a result of the continued expansion of our retail and specialty sales segments. Whole bean and related sales increased 10.5%, to $16.7 million and beverage and pastry sales increased

18.3%, to $12.1 million.

In the retail segment our revenue increased by $2.0 million primarily as a result of increased sales from the 12 stores we opened since August 2002 and secondarily from existing stores. Sales of whole bean coffee and related products in the retail segment increased by 1.2%, to $8.8 million, while sales of beverages and pastries increased by 19.0% to $11.9 million. The increase in beverage and pastry sales is primarily due to the introduction, during the second quarter, of new iced drinks and a revamped bar menu that emphasizes many of our customer favorites. The slower growth in whole bean and related products was due to cannibalization of bean sales in retail stores as we increase the availability of Peet's coffee in grocery stores, and the slower maturation of whole bean sales in new stores. We opened 3 new stores during this quarter, and expect to open 3 more stores in the fourth quarter.

In the specialty sales segment, revenue increased as the result of our continued focus on the grocery and foodservice channel. The $1.5 million increase consisted primarily of a $1.0 million increase in grocery sales and a $0.5 million increase in sales to restaurants and foodservice companies. The increase in the grocery channel sales was primarily due to sales to approximately 2,400 new stores we added during the last 15 months. The increased sales were also driven by the transition, during the first quarter, to a direct store delivery system, where our own route sales representatives deliver to stores weekly, from warehouse distribution. We believe the direct store delivery system ensures freshness through proper rotation and weekly delivery, optimizes store specific item assortments, achieves proper shelf space and improves free-standing display levels. The increase was offset partially by the initial pipeline load-in for the introduction of Peet's into 1,200 Safeway stores. In the restaurant and foodservice area, the sales increase was primarily due to new accounts added last year and earlier this year such as Omni Hotels.

COST OF SALES AND RELATED OCCUPANCY EXPENSES

Cost of sales and related occupancy expenses consist of product costs, including hedging costs, and manufacturing costs, rent and other occupancy costs. Cost of sales as a percent of net revenue increased 0.2% primarily due to the 12 new stores we opened during the last 14 months. Due to their lower volume, the new stores have higher occupancy, food and beverage costs as a percent of sales. Existing stores actually had an improvement in cost of sales and related occupancy costs due to higher price points generated from new iced drinks and revamped bar menu. Specialty sales costs were in line with prior year.

OPERATING EXPENSES

Operating expenses as a percent of net revenue for the current thirteen week period increased as compared to the same prior year period due to the higher operating expenses of the direct store delivery system with our own route sales representatives. Specialty sales operating expenses as a percent of segment revenue was 24.7% compared to 22.2% in prior year. Retail operating expenses were in line with prior year as higher operating expenses from new stores were offset by improved operation of our existing stores.

MARKETING AND ADVERTISING EXPENSES

Marketing and advertising expenses was 3.3% of net revenue, or $0.2 million less than prior year. The marketing spending level reflects our normal number of initiatives and within our expected full year spending of 4.0% of net revenue.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses in the current thirteen week period were $4.9 million, or 16.9% of revenue compared to $1.4 million, or 5.5% for the

same period last year. The $3.5 million increase was primarily due to the $3.4 million, or 11.8% of net revenue, charge related to the settlement of the wage and hour lawsuit and severance expenses related to the departure of two executives. The settlement is subject to risks identified in Note 7 of the "Notes to Condensed Consolidated Financial Statements."

DEPRECIATION AND AMORTIZATION EXPENSES

Depreciation and amortization expenses increased in the thirteen week period as compared to the same prior year period due primarily to the 12 stores we opened during the last 14 months. The expenses were partially offset by older assets becoming fully depreciated.

INVESTMENT INCOME, NET

We currently invest our secondary public offering proceeds and excess cash in short-term and long-term interest-bearing, U.S. government and agency securities. Investment income includes interest income and gains from the sale of these instruments. We realized $284,000 in investment gains and received $215,000 in interest income in this quarter compared to $220,000 in interest income in the same prior year quarter.

PROVISION FOR INCOME TAXES

As a result of reduced taxable income due to the charges taken during this thirteen week period and the tax benefits from the exercising of options, we do not expect to have a cash tax liability for this year. Therefore, we can no longer utilize some charitable contribution carry forwards that were planned to partially offset our tax liability. Consequently, we expect the tax rate to increase to 40.2% for the full year. In the current period we adjusted the year-to-date tax provision to reflect this rate. As a result, our effective tax rate for the third quarter of 2003 was 27.9% of our operating loss.

THIRTY-NINE WEEKS ENDED SEPTEMBER 28, 2003 COMPARED TO THIRTY-NINE WEEKS ENDED SEPTEMBER 29, 2002

NET REVENUE

Net revenue for the thirty-nine weeks ended September 28, 2003 increased 14.2% as compared to same period in 2002. Whole bean and related sales increased 14.5% to $50.1 million and beverage and pastry sales increased 13.8% to $35.2 million.

In the retail segment, sales increased by 8.5% primarily due to the sales from 12 new stores we opened since August 2002 and increased sales from existing stores resulting from the introduction of new iced drinks and an expanded menu. In the specialty sales segment, sales increased by 32.6% primarily due to new accounts added in the grocery channel and strong volume growth in the restaurant and foodservice areas.

COST OF SALES AND RELATED OCCUPANCY EXPENSES

Cost of sales and related occupancy expenses increased by 13.2% as a result of opening 12 new stores during the last 14 months. Cost of sales as a percent of net revenue decreased primarily due to the revamped bar menu and introduction new ice drinks that resulted in higher price points and better cost management through standardization of bar coffee rotation.

OPERATING EXPENSES

Operating expenses increased as compared to the same prior year period as we grew our business. As a percent of net revenue, operating expenses increased primarily due to the conversion to a direct store delivery method of distribution for our grocery business and the 12 new stores we opened during the last 14 months.

MARKETING AND ADVERTISING EXPENSES

Marketing and advertising expenses decreased as a percent of revenue by 0.7 percentage points as compared to the same prior year period as we were able to leverage these costs by holding the spending relatively flat to last year while sales grew 14.2%.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative expenses increased 42.1%, or $2.3 million, due to the litigation settlement and severance expenses related to the departure of two executives. The increase was partially offset by the restructuring of the executive bonus program and reduced expenses in the areas of stock plan administration and proxy related activities.

PROVISION FOR INCOME TAXES

Our effective tax rate for year to date was 40.2% compared to 37.0% in the same prior year period. The tax rate reflects our loss position for the quarter as well as a catch-up adjustment for our full year expected tax rate. As a result of reduced taxable income due to the charge taken this quarter and the tax benefits from the exercising of options, we do not expect to have a cash tax liability for this year. Therefore, we can no longer utilize some charitable contribution carry forwards that we were planned to partially offset our tax liability. Consequently, we expect the tax rate to increase to 40.2% for the full year. The prior year's tax rate of 37.0% reflected a 3.0 percentage point benefit due to the utilization of previous years' carryforwards.

LIQUIDITY AND CAPITAL RESOURCES

At September 28, 2003, we had $27.2 million in total cash and cash equivalents, of which $15.9 million is invested in short-term U.S. government and agency securities. We also had $25.0 million of long-term U.S. government and agency securities. Working capital was $32.6 million at September 28, 2003.

Net cash provided by operations was $7.3 million during the first thirty-nine weeks of 2003 compared to $5.4 million in the same prior year period. Operating cash flows were positively impacted by net income adjusted for depreciation and amortization and the net tax benefit of stock options exercised during the year.

Net cash used in investing activities was $4.9 million during the first thirty-nine weeks of 2003 compared to $32.7 million in the same prior year period, which was primarily due to the purchase of $27.7 million invested in long-term U.S. government securities. Investing activities primarily consisted of the purchase of $8.0 million of property, plant and equipment for new stores, support systems upgrades and plant packaging equipment to support the growth in specialty sales. This was offset by net proceeds from sale of long-term investments of $3.1 million.

Net cash provided by financing activities was $5.1 million during the first thirty-nine weeks of 2003. Financing activities during the period consisted primarily of the exercise of stock options and sales of our common stock to our employees through our employee stock purchase plan.

We have a credit facility with General Electric Capital Corporation, which provides for a revolving line of credit of $15.0 million through September 2005. Total availability under the revolving line of credit is determined by subtracting our funded debt from its trailing twelve month earnings before interest, taxes, depreciation and amortization, or EBITDA, multiplied by 2.50. As of September 28, 2003, there was no outstanding balance and we had $14.4 million available under the revolving line of credit with other senior funded debt of $0.5 million.

In December 1995, we obtained financing under industrial development revenue bonds issued by California Statewide Communities Development Authority. Outstanding amounts under the bonds bear interest based on a floating rate determined by prevailing market conditions for comparable tax-exempt obligations until maturity on December 1, 2006. Interest is payable monthly and principal of $0.1 million is payable quarterly each February, May, August, and November. As of September 28, 2003, we have an outstanding standby letter of credit of $0.9 million backing this long-term borrowing. The reducing standby letter of credit bears an annual interest charge of 1.25% payable monthly. On October 1, 2003, we have repaid the entire outstanding balance of the bonds and canceled the standby letter of credit.

Our 2003 capital expenditure requirements consist primarily of expenditures relating to new store openings, remodeling of existing stores, upgrade of our packaging system and continued improvement of our data processing capabilities. During the first thirty-nine weeks of 2003, we spent $8.0 million. Our remaining 2003 capital expenditures are expected to be between $1.0 and $2.0 million. Approximately $1.0 million is expected to be used for the opening of the remaining new retail stores scheduled for 2003 and expenditures for new stores in progress for 2004. The remaining $1.0 million is expected to be used for the remodeling of existing stores and information technology enhancements.

The following table sets forth our contractual cash obligations and our other commercial commitments as of September 28, 2003.

	PAYMENTS DUE BY PERIOD (IN THOUSANDS)				
CONTRACTUAL OBLIGATIONS	TOTAL	LESS THAN 1 YEAR	1-3 YEARS	4-5 YEARS	AFTER 5 YEA
Industrial development revenue bonds. .	$ 530	$ 440	$ 90		
Equipment leases.	296	69	130	$ 97	
Retail store operating leases	25,654	5,729	10,085	5,758	$ 4,
Fixed-price coffee purchase commitments	12,877	10,558	2,220	99	
Total contractual cash obligations	$39,357	$ 16,796	$ 12,525	$ 5,954	$ 4,

On October 1, 2003, we have repaid the entire outstanding balance of the bonds and canceled the standby letter of credit.

We expect cash flows from operations and the borrowing capacity under our current line of credit to be sufficient for our operating requirements for at least the next twelve months and to meet our contractual obligations as they come due.

RECENT ACCOUNTING PRONOUNCEMENTS

During April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under Statement 133. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively. The adoption of SFAS No. 149 did not have a significant impact on our operating results or financial

position.

During May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." SFAS No. 150 clarifies the accounting for certain financial instruments with characteristics of both liabilities and equity and requires that those instruments be classified as liabilities in statements of financial position. Previously, many of those financial instruments were classified as equity. SFAS No. 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 SFAS No. 150 did not have a significant impact on our operating results or financial position.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Although we have no borrowings on our credit facility, if we chose to, our cost for financing would be exposed to market risk from changes in interest rates on any outstanding bank debt. Our revolving line of credit bears interest at certain applicable margin levels contingent upon our leverage ratio on a quarterly basis. The interest rate, which is either the Index rate (the higher of prime or 50 basis points over the average of rates for overnight federal funds transactions) plus a range from 0.00% to 0.25% or a rate equal to LIBOR plus a range from 2.00% to 2.50%, increases as our leverage ratio increases. Adjustments to the applicable margin level are implemented quarterly on a prospective basis. The interest cost of our bank debt is affected by changes in either prime, federal funds rates, or LIBOR. Such changes could adversely impact the cost of our borrowings.

The supply and price of coffee are subject to volatility and can be affected by multiple factors in the producing countries, including weather, political and economic conditions. In addition, green coffee prices have been affected in the past, and may be affected in the future, by the actions of certain organizations and associations that have historically attempted to influence commodity prices of green coffee through agreements establishing export quotas or restricting coffee supplies worldwide. With this in mind, we purchase coffee from three distinct regions and many countries around the world.

Our hedging strategy is intended to limit the cost exposure of the main commodity used in our business, green coffee beans. We use the following instruments to manage coffee supply and price risk:

- Fixed-price purchase commitments;
- Coffee futures; and
- Coffee futures options.

From time to time, we may use coffee futures and coffee futures options depending on market conditions to reduce the price risk of our coffee purchase requirements that we cannot make or have not made through contractual commitments to purchase physical lots of coffee. These coffee futures and coffee futures options are traded on the New York Coffee, Sugar & Cocoa Exchange. We may use these futures and options solely for financial hedging purposes and never take actual delivery of the coffee traded on the exchange. We have no outstanding hedging contracts as of September 28, 2003.

As of September 28, 2003, we had approximately $12.9 million in open fixed-priced purchase commitments with delivery dates ranging from July 2003 through November 2006. We believe, based on relationships established with our suppliers in the past that the risk of non-delivery on such purchase commitments is remote.

There have been no substantial changes in the nature of our risks since December 29, 2002. Please refer to our Annual Report on Form 10-K for the year ended December 29, 2002.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer (the "CEO") and Chief Financial Officer (the "CFO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of September 28, 2003. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective. There have been no material changes in the Company's internal controls or in other factors that could materially affect internal controls.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On February 25, 2003 and March 7, 2003, two lawsuits were filed against the Company entitled Brian Taraz, et al vs. Peet's Coffee & Tea, Inc., and Tracy Coffee, et al. vs. Peet's Coffee & Tea, Inc. Each was filed in Superior Court of the State of California, County of Orange, and sought class action certification. These suits were filed by one former and one current store manager alleging misclassification of employment position and sought damages, restitution, reclassification and attorneys' fees and costs. On October 27, 2003, the Company announced that it had reached an agreement in principle to settle the lawsuits to fully resolve all claims brought by the plaintiffs without engaging in protracted litigation. The Company recorded a charge during the third quarter for the estimated payment of claims to eligible class members, attorneys' fees and costs, costs to a third-party claims administrator, as well as applicable employer payroll taxes, which is included in "General and administrative expenses" on the accompanying condensed consolidated statements of operations for the thirteen and thirty-nine weeks ended September 28, 2003. The settlement is subject to the court's final approval and the Company's right to terminate if more than 10% of the settlement class opts out of the settlement.

In addition to the lawsuits described above, we may from time to time become involved in certain legal proceedings in the ordinary course of business. Currently, the Company is not party to any other legal proceedings that management believes would have a material adverse effect on the financial position or results of operations of the Company.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

a. Exhibits

Exhibit Number	Description
10.17	Peet's Coffee & Tea, Inc. Key Employment Agreement for Chief Financial Officer dated as of June 25, 2003. (1)
31.1	Certification of the Company's Chief Executive Officer, Patrick O'Dea, pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended.
31.2	Certification of the Company's Chief Financial Officer, Thomas Cawley,

	pursuant to Rule 13a-15(a) under the Securities Exchange Act of 1934, as amended.
32.1	Certification of the Company's Chief Executive Officer, Patrick O'Dea, pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
32.2	Certification of the Company's Chief Financial Officer, Thomas Cawley, pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

(1) Management contract.

b. Reports on Form 8-K

Current Report on Form 8-K filed on June 30, 2003 to furnish under Item 12 a press release dated June 30, 2003.

Current Report on Form 8-K filed on July 30, 2003 to furnish under Item 12 a press release dated July 30, 2003.

SIGNATURES

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

Date: November 12, 2003

PEET'S COFFEE & TEA, INC.
By: /s/ Thomas Cawley

Thomas Cawley
Vice President, Chief Financial Officer, and Secretary