FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filing Date: **2004-08-12** | Period of Report: **2004-07-03**
SEC Accession No. 0000950117-04-002927

(HTML Version on secdatabase.com)

FILER

QUAKER FABRIC CORP /DE/

CIK:**103341**| IRS No.: **041933106** | State of Incorp.:**DE** | Fiscal Year End: **0102**
Type: **10-Q** | Act: **34** | File No.: **001-07023** | Film No.: **04969245**
SIC: **2221** Broadwoven fabric mills, man made fiber & silk

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5086781951

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

(Mark One)

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

For the quarterly period ended July 3, 2004

OR

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

Commission file number 1-7023

QUAKER FABRIC CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	04-1933106
(State of incorporation)	(I.R.S. Employer Identification No.)

941 Grinnell Street, Fall River, Massachusetts 02721
(Address of principal executive offices)

(508) 678-1951
(Registrant's telephone number, including area code)

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

Yes X No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes X No

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

As of August 11, 2004, 16,820,818 shares of Registrant's Common Stock, $0.01 par value, were outstanding.

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Quarterly Report on Form 10-Q
Quarter ending July 3, 2004

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PART I - FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

QUAKER FABRIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share amounts)

<TABLE>
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	July 3, 2004	January 3, 2004
ASSETS	(Unaudited)	(Audited)
<S>	<C>	<C>
Current assets:		
Cash and cash equivalents	$ 8,101	$ 5,591
Accounts receivable, less reserves of $1,927 and $2,089 at July 3, 2004 and January 3, 2004, respectively	42,686	44,374
Inventories	46,890	43,987
Prepaid and deferred income taxes	1,136	1,038
Production supplies	1,934	1,727
Prepaid insurance	1,337	2,132
Other current assets	8,481	7,842
Total current assets	110,565	106,691
Property, plant and equipment, net	160,455	162,293
Other assets:		
Goodwill	5,432	5,432
Other assets	1,820	1,862
Total assets	$278,272	$276,278
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of debt	$ 5,000	$ 5,000
Accounts payable	15,765	14,386
Accrued expenses	11,953	13,137
Total current liabilities	32,718	32,523
Long-term debt	40,000	40,000
Deferred income taxes	32,313	31,634
Other long-term liabilities	2,763	2,616

Redeemable preferred stock:		
Series A convertible, $0.01 par value per share, liquidation preference $1,000 per share, 50,000 shares authorized, none issued	--	--
Stockholders' equity:		
Common stock, $0.01 par value per share, 40,000,000 shares authorized; 16,820,818 and 16,795,818 shares issued and outstanding as of July 3, 2004 and January 3, 2004, respectively	168	168
Additional paid-in capital	89,047	88,870
Unearned compensation	(592)	(695)
Retained earnings	84,175	83,228
Other accumulated comprehensive loss	(2,320)	(2,066)
Total stockholders' equity	170,478	169,505
Total liabilities and stockholders' equity	$278,272	$276,278

</TABLE>

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

QUAKER FABRIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Amounts in thousands, except per share amounts)

<TABLE>
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	Three Months Ended		Six Months Ended	
	July 3, 2004	July 5, 2003	July 3, 2004	July 5, 2003
	(Unaudited)		(Unaudited)	
<S>	<C>	<C>	<C>	<C>
Net sales	$73,132	$73,886	$157,516	$164,111
Cost of products sold	59,733	59,401	125,422	130,659
Gross profit	13,399	14,485	32,094	33,452
Selling, general and administrative expenses	13,381	13,298	27,406	27,549
Operating income	18	1,187	4,688	5,903
Other expenses:				
Interest expense	860	991	1,707	2,060
Other, net	(36)	113	(52)	89
Income (loss) before provision for income taxes	(806)	83	3,033	3,754
Provision (benefit) for income taxes	(324)	(82)	1,077	1,276
Net income (loss)	$ (482)	$ 165	$ 1,956	$ 2,478
Earnings (loss) per common share - basic (Note 1)	$ (0.03)	$ 0.01	$ 0.12	$ 0.15
Earnings (loss) per common share - diluted (Note 1)	$ (0.03)	$ 0.01	$ 0.11	$ 0.15
Dividends per common share	$ 0.030	$ 0.025	$ 0.060	$ 0.050
Weighted average shares outstanding - basic (Note 1)	16,820	16,724	16,815	16,570
Weighted average shares outstanding - diluted (Note 1)	17,141	16,950	17,224	16,857

</TABLE>

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

QUAKER FABRIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Amounts in thousands)

<TABLE>
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	Three Months Ended July 3, 2004 (Unaudited)	Three Months Ended July 5, 2003 (Unaudited)	Six Months Ended July 3, 2004 (Unaudited)	Six Months Ended July 5, 2003 (Unaudited)
<S>	<C>	<C>	<C>	<C>
Net income (loss)	$(482)	$165	$1,956	$2,478
Other comprehensive income (loss)				
Foreign currency translation adjustments	(243)	217	(246)	182
Unrealized gain (loss) on hedging instruments	27	18	(8)	--
Other comprehensive income (loss)	(216)	235	(254)	182
Comprehensive income (loss)	$(698)	$400	$1,702	$2,660

</TABLE>

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

QUAKER FABRIC CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)

<TABLE>
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	Six Months Ended July 3, 2004 (Unaudited)	Six Months Ended July 5, 2003 (Unaudited)
<S>	<C>	<C>
Cash flows from operating activities:		
Net income	$ 1,956	$ 2,478
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,797	9,599
Amortization of unearned compensation	103	99
Deferred income taxes	679	853
Tax benefit related to exercise of common stock options	40	402
Changes in operating assets and liabilities:		

Accounts receivable	1,581	1,885
Inventories	(2,995)	6,624
Prepaid expenses and other assets	(134)	1,491
Accounts payable and accrued expenses	195	(6,007)
Other long-term liabilities	147	287
Net cash provided by operating activities	11,369	17,711
Cash flows from investing activities:		
Purchase of property, plant and equipment	(7,932)	(3,844)
Cash flows from financing activities:		
Change in revolving credit facility	- -	(13,700)
Proceeds from exercise of common stock options and issuance of shares under the employee stock purchase plan	137	603
Cash dividends	(1,009)	(836)
Net cash used in financing activities	(872)	(13,933)
Effect of exchange rates on cash	(55)	(10)
Net increase (decrease) in cash	2,510	(76)
Cash and cash equivalents, beginning of period	5,591	1,098
Cash and cash equivalents, end of period	$ 8,101	$ 1,022

</TABLE>

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

QUAKER FABRIC CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Amounts in thousands, except per share amounts)

Note 1 - BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements reflect all normal and recurring adjustments that are, in the opinion of management, necessary to present fairly the financial position, results of operations and cash flows for the interim periods presented. The unaudited consolidated financial statements have been prepared pursuant to the instructions to Form 10-Q and Rule 10-01 of regulation S-X of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been omitted pursuant to those rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. Operating results for the six months ended July 3, 2004 are not necessarily indicative of the results expected for the full fiscal year or any future period. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended January 3, 2004.

Earnings Per Common Share

Basic earnings per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. For diluted earnings per share, the denominator also includes dilutive outstanding stock options determined using the treasury stock method. The following table reconciles weighted average common shares outstanding to weighted average common shares outstanding and dilutive potential common shares.

<TABLE>
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	Three Months Ended		Six Months Ended	
	July 3, 2004	July 5, 2003	July 3, 2004	July 5, 2003
	(In thousands)			
<S>	<C>	<C>	<C>	<C>
Weighted average common shares outstanding	16,820	16,724	16,815	16,570
Dilutive potential common shares	321	226	409	287
Weighted average common shares outstanding and dilutive potential common shares	17,141	16,950	17,224	16,857
Antidilutive options	1,572	1,838	1,032	1,838

</TABLE>

Note 2 - INVENTORIES

Inventories are stated at the lower of cost or market and include materials, labor and overhead. A standard cost system is used and approximates cost on a first-in, first-out (FIFO) basis. Cost for financial reporting purposes is determined using the last-in, first-out (LIFO) method.

Inventories at July 3, 2004 and January 3, 2004 consisted of the following:

<TABLE>
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	July 3, 2004	January 3, 2004
<S>	<C>	<C>
Raw materials	$21,628	$19,714
Work-in-process	6,506	7,709
Finished goods	17,032	12,484
Inventory at FIFO	45,166	39,907
LIFO adjustment	1,724	4,080
Inventory at LIFO	$46,890	$43,987

</TABLE>

LIFO inventory values are higher than FIFO costs because current manufacturing costs are lower than the older historical costs used to value inventory on a LIFO basis.

Note 3 - SEGMENT REPORTING

The Company operates as a single business segment consisting of sales of two products, upholstery fabric and specialty yarns. Management evaluates the Company's financial performance in the aggregate and allocates the Company's resources without distinguishing between yarn and fabric products.

Net sales to unaffiliated customers by major geographical area were as follows:

	Three Months Ended		Six Months Ended	
	July 3, 2004	July 5, 2003	July 3, 2004	July 5, 2003
	(In thousands)			
United States	$64,235	$64,787	$139,473	$145,796
Canada	3,444	3,455	6,885	7,175
Mexico	1,689	2,386	4,027	4,808
Middle East	1,169	668	1,858	1,121
South America	615	569	1,293	1,165
Europe	936	931	2,047	1,973
All Other	1,044	1,090	1,933	2,073
	$73,132	$73,886	$157,516	$164,111

Net sales by product category are as follows:

	Three Months Ended		Six Months Ended	
	July 3, 2004	July 5, 2003	July 3, 2004	July 5, 2003
	(In thousands)			
Fabric	$66,599	$71,463	$144,559	$158,335
Yarn	6,196	2,199	12,208	5,187
Other	337	224	749	589
	$73,132	$73,886	$157,516	$164,111

Note 4 - ACCOUNTING FOR STOCK BASED COMPENSATION

Accounting for Stock-Based Compensation. The Company follows Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB No. 25"), in accounting for its employee stock option and employee stock purchase plans, rather than the fair value method of accounting provided under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"). Under APB No. 25, the Company accounts for its employee stock options using the intrinsic value method. Under this method the Company does not recognize compensation expense on stock options granted to employees when the exercise price of each option is greater than or equal to the market price of the underlying stock on the date of the grant.

The following pro forma information presents the Company's net income and basic and diluted net income per share for the three months and six months ended July 3, 2004 and July 5, 2003 as if compensation cost had been measured under the fair value method of SFAS No. 123, "Accounting for Stock Based Employee Compensation," for stock option grants and shares

issued under the employee stock option and employee stock purchase plans, respectively. The Company utilizes the Black-Scholes option pricing model to estimate the fair value of options.

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	Three Months Ended		Six Months Ended	
	July 3, 2004	July 5, 2003	July 3, 2004	July 5, 2003
	(In thousands)		(In thousands)	
	(Unaudited)		(Unaudited)	
<S>	<C>	<C>	<C>	<C>
Net income (loss), as reported	$ (482)	$165	$1,956	$2,478
Add: Stock-based employee compensation expense included in net income, net of related tax effects	33	34	66	65
Less: Stock-based employee compensation expense determined under Black-Scholes option pricing model, net of related tax effects	(306)	(264)	(601)	(528)
Pro forma net income (loss):	$(755)	$(65)	$1,421	$2,015
Earnings (loss) per common share - basic				
As reported	$(0.03)	$0.01	$0.12	$0.15
Pro forma	$(0.04)	$0.00	$0.08	$0.12
Earnings (loss) per common share - diluted				
As reported	$(0.03)	$0.01	$0.11	$0.15
Pro forma	$(0.04)	$0.00	$0.08	$0.12

</TABLE>

Note 5 - COMMITMENTS AND CONTINGENCIES

(a) Income Taxes. The Company is currently challenging tax assessments from the Internal Revenue Service for the years 1997-1999 and from the Massachusetts Department of Revenue for the years 1993-1998. In addition, during the third quarter of 2003, the Company filed amended tax returns for these and subsequent years to claim approximately $3,500 of federal and state research and development credits. Audits of these amended returns commenced during October 2003. There is significant uncertainty surrounding the amount and timing of the benefit that will be ultimately realized. The Company believes that it has a supportable basis for claiming these credits, but the amounts are subject to ongoing audits by federal and state authorities. Accordingly, the Company has not reflected the potential benefits of these credits in its financial statements for these or subsequent years. No benefit will be recognized in the financial statements until these gain contingencies are resolved through the eventual disposition with the respective tax authorities.

(b) Litigation. In the ordinary course of business, the Company is party to various types of litigation. The Company believes it has meritorious defenses to all claims and in its opinion, all litigation currently pending or threatened will not have a material effect on the Company's financial position, results of operations or liquidity.

(c) Environmental Cleanup Matters. The Company accrues for estimated costs associated with known environmental matters when such costs are probable and can be

reasonably estimated. The actual costs to be incurred for environmental remediation may vary from estimates, given the inherent uncertainties in evaluating and estimating environmental liabilities, including the possible effects of changing laws and regulations, the stage of the remediation process and the magnitude of contamination found as the remediation progresses.

During 2003, the Company entered into agreements with the Massachusetts Department of Environmental Protection to install air pollution control equipment at one of its manufacturing plants in Fall River, Massachusetts. Management anticipates that the costs associated with the acquisition and installation of the equipment will total approximately $900 over a three-year period, which began in 2003. These costs will be capitalized and depreciated over the estimated useful life. Management believes the ultimate disposition of known environmental matters will not have a material adverse effect on the liquidity, capital resources, business or consolidated financial position of the Company.

Note 6 - INCOME TAXES

The Company determines its periodic income tax expense based upon the current period income and the estimated annual effective tax rate for the Company. The rate is revised, if necessary, as of the end of each successive interim period during the fiscal year to the Company's best current estimate of its annual effective tax rate.

Note 7 - NEW FACILITY ACQUISITION

On July 2, 2004, the Company entered into a purchase and sale agreement to acquire for $21.0 million a single story industrial building located on 33.6 acres of land in Fall River, Massachusetts. The Company anticipates that it may utilize borrowings under the Credit Agreement (as hereafter defined) as the initial source of the funds to complete the transaction, but that it will also review alternative financing strategies, which may include the designation of an unrelated third party to take title to the property which would then be leased to Quaker. Completion of the purchase or long-term lease of this facility is anticipated during the fourth quarter of 2004. By the end of 2005, the Company plans to have moved four of the manufacturing and warehousing operations currently being conducted in leased facilities into this new facility. The Company anticipates that it will incur a short-term increase in operating expenses of approximately $2.1 million during the transition to this new facility. Approximately $1.6 million will be moving and lease termination costs and another $0.5 million attributable to the duplication of certain facilities-related expenses.

Note 8 - New Accounting Pronouncements

Consolidation of Variable Interest Entities

In January 2003, FASB issued Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities," which clarifies the application of Accounting Research Bulletin (ARB) No. 51, "Consolidated Financial Statements," relating to consolidation of certain entities. First, FIN 46 will require identification of the Company's participation in variable interest entities (VIE), which are defined as entities with a level of invested equity that is not sufficient to fund future activities to permit them to operate on a stand alone basis, or whose equity holders lack certain characteristics of a controlling financial interest. Then, for entities identified as VIE, FIN 46 sets

forth a model to evaluate potential consolidation based on an assessment of which party to the VIE, if any, bears a majority of the exposure to its expected losses, or stands to gain from a majority of its expected returns. In December 2003, the FASB issued a revised FIN 46 ("FIN 46R") to defer the effective date and provide further clarification on the interpretation. FIN 46R is effective for public companies in the first fiscal period after December 15, 2003. The Company does not have any interests that would qualify as a variable interest entity and therefore the adoption of FIN 46 does not have an effect on the Company's results of operations and financial condition.

Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity

In May 2003, the FASB issued SFAS 150, Accounting For Certain Financial Instruments with Characteristics of Both Liabilities and Equity (SFAS 150), which establishes standards for how an issuer of financial instruments classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on a fixed monetary amount known at inception, variations in something other than the fair value of the issuer's equity shares or variations inversely related to changes in the fair value of the issuer's equity shares. In November 2003, the FASB deferred the effective date for applying the provisions of SFAS 150 for mandatorily redeemable financial instruments that have a fixed redemption period to be effective for fiscal periods beginning after December 15, 2003. For all other mandatorily redeemable financial instruments, the disclosure provisions of SFAS 150 have been deferred for an indefinite period. The adoption of this standard did not have any impact on the Company's financial position or results of operations.

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

The Company's fiscal year is a 52 or 53 week period ending on the Saturday closest to January 1. "Fiscal 2003" was a 52 week period ended January 3, 2004 and "Fiscal 2004" will be a 52 week period ending January 1, 2005. The first six months of Fiscal 2003 and Fiscal 2004 ended July 5, 2003 and July 3, 2004, respectively.

Critical Accounting Policies

The Company considered the disclosure requirements of Financial Reporting Release No. 60 regarding critical accounting policies and Financial Reporting Release No. 61 regarding liquidity and capital resources, certain trading activities and related party/certain other disclosures, and concluded that there were no material changes in these areas during the first six months of 2004 that would warrant further disclosure beyond those matters previously disclosed in the Company's Annual Report on Form 10-K for the year ended January 3, 2004.

General

Quaker is a leading designer, manufacturer and worldwide marketer of a broad range of woven upholstery fabrics, which it sells at various price points primarily to manufacturers of residential furniture. The Company is also a leading developer and manufacturer of specialty yarns. Approximately 11.5% of the Company's revenues during the first six months of 2004 were attributable to fabrics sold outside the United States and approximately 65.0% of Quaker's fabrics are manufactured to customer order.

Competition in the industry is intense, from both domestic fabric mills and fabric mills located outside the U.S. manufacturing products for sale into the U.S. market. Management believes that competition in the U.S. domestic market may intensify following the January 1, 2005 expiration of the quotas imposed under the Uruguay Round Agreement on Textiles and Clothing on textile and apparel products coming into the U.S. The Company's fabric products compete with other furniture coverings, including leather, suede, prints, tufts, flocks and velvets, for consumer acceptance. Consumer tastes in upholstered furniture coverings are somewhat cyclical and do change over time, with various coverings gaining or losing share depending on changes in home furnishing trends. For example, leather and suede furniture has enjoyed growing popularity over the past few years, to some extent at the expense of woven fabrics, such as the Jacquards and other woven fabrics Quaker manufactures. As a result, overall domestic demand for furniture covered with woven upholstery products is currently somewhat weaker than demand for other types of furniture, including furniture covered with leather and suede products. In addition, company sales into some foreign markets have been hurt by market-specific geopolitical and macroeconomic factors reducing aggregate demand in these locations.

Competitive factors in the industry include product design, product pricing, customer service and quality. Competition from lower cost imported products has increased, particularly those products coming into the United States from China and other parts of Asia. Management considers such factors as incoming customer order rates, size of production backlog, manufacturing efficiencies, product mix and price points in evaluating the Company's financial condition and operating performance. Incoming fabric orders during the first six months of 2004 were down approximately 10.4% compared to the first six months of 2003. The total backlog of fabric and yarn products at the end of the first six months of 2004 was down 11.9% compared to that of a year ago. The dollar value of the yarn backlog was up $2.0 million or 143.3%, while the dollar value of the fabric backlog was down $4.9 million or 21.3%. Management will continue to aggressively pursue its core strategy of building profitable volume by providing the market with the best products and service.

Results of Operations - Quarterly Comparison

Net sales for the second quarter of 2004 decreased $0.8 million or 1.0%, to $73.1 million from $73.9 million for the second quarter of 2003. Net fabric sales within the United States decreased 7.3%, to $58.0 million in the second quarter of 2004 from $62.6 million in the second quarter of 2003, primarily due to increased competition from leather and lower priced imported suede products. In addition, overall domestic furniture demand appears to be lagging the U.S. economic recovery as a whole, with the upholstered furniture category trailing aggregate demand for furniture. The overall weighted average sales price per yard increased 1.9%, to $5.77 for the second quarter of 2004 from $5.66 for the second quarter of 2003 due to a slight shift in product mix to middle to better-end fabrics and an increase of 3.0% in the average price point of middle to better-end fabrics. Foreign and Export sales were essentially the same at approximately $9.0 million for both quarters. Net yarn sales increased 181.8%, to $6.2 million in the second quarter

of 2004 from $2.2 million in the same period of 2003. This improvement in the yarn sales segment is due to the penetration of new markets, particularly the craft yarn category.

The Company's dollar value of incoming orders during the second quarter of 2004 decreased approximately 6.2% compared to the second quarter of 2003. The dollar value of the backlog decreased by approximately 11.9%, to $21.6 million at the end of the second quarter of 2004 as compared to $24.5 million at the end of the same period in 2003, with the dollar value of the fabric backlog down 21.3% and the dollar value of the yarn backlog up 143.3%.

The gross profit margin for the second quarter of 2004 decreased to 18.3% from 19.6% in the second quarter of 2003. The decrease in the gross margin percentage resulted primarily from lower weekly production and shipping rates and higher payroll-related unemployment taxes.

Selling, general and administrative expenses increased slightly to $13.4 million in the second quarter of 2004 from $13.3 million in the second quarter of 2003. Higher costs were incurred in the second quarter of 2004 as compared to the second quarter of 2003 in several semi-variable expense categories, such as expenditures for professional fees and certain wage and fringe benefit expenses. Selling, general and administrative expenses as a percentage of net sales increased to 18.3% in the second quarter of 2004 from 18.0% in the second quarter of 2003. This increase as a percentage of net sales was due to lower net sales in combination with the above mentioned higher expenses in the second quarter of 2004 compared to the same period in 2003.

Interest expense was $0.9 million for the second quarter of 2004 and $1.0 million for the second quarter of 2003. Lower levels of both variable and fixed rate debt in the second quarter of 2004 resulted in the decline in interest expense.

The Company provides for income taxes on an interim basis, using an estimated annual effective income tax rate. The Company's estimated tax rate was 35.4% for 2003 and 36.5% for the first quarter of 2004. The Company has adjusted the estimated annual effective tax rate for 2004 downward to 35.5%. This reduction in the tax rate is due to lower levels of projected income for 2004 reducing the effective statutory federal income tax rate from 35% to approximately 34% and an increased estimated benefit to the tax rate from the Extraterritorial Income Exclusion. The effective income tax rate is lower than the combined federal and state statutory rates, due primarily to certain tax benefits related to extraterritorial income at the federal level and investment tax credits at the state level.

The Company is currently challenging tax assessments from the Internal Revenue Service for the years 1997-1999 and from the Massachusetts Department of Revenue for the years 1993-1998. In addition, during the third quarter of Fiscal 2003 the Company filed amended tax returns for these and subsequent years to claim approximately $3.5 million of federal and state research and development credits. Audits of these amended returns commenced during October 2003. There is significant uncertainty surrounding the amount and timing of the benefit that will be ultimately realized. The Company believes that it has a supportable basis for claiming these credits, but the amounts are subject to ongoing audits by federal and state authorities. Accordingly, the Company has not reflected the potential benefits of these credits in its financial statements for these or subsequent years. No benefit will be recognized in the financial statements until these gain contingencies are resolved through the eventual disposition with the respective tax authorities.

The Company incurred a net loss in the second quarter of 2004 of ($0.5) million or ($0.03) per common share-diluted, compared to net income of $0.2 million or $0.01 per common share-diluted for the second quarter of 2003.

Results of Operations - Six-month Comparison

Net sales for the first half of 2004 decreased $6.6 million or 4.0%, to $157.5 million from $164.1 million for the first half of 2003. Net fabric sales within the United States decreased 9.5%, to $127.3 million in the first half of 2004 from $140.6 million in the first half of 2003, primarily due to increased competition from leather and lower priced imported suede products. In addition, overall domestic furniture demand appears to be lagging the U.S. economic recovery as a whole, with the upholstered furniture category trailing aggregate demand for furniture. The overall weighted average sales price per yard increased 2.2%, to $5.70 for the first half of 2004 from $5.58 for the first half of 2003 due to a slight shift in product mix to middle to better-end fabrics and an increase of 3.0% in the average price point of middle to better-end fabrics. Foreign and Export sales were essentially the same at approximately $18.0 million for both six month periods. Net yarn sales increased 134.6%, to $12.2 million in the first half of 2004 from $5.2 million in the same period of 2003. This improvement in the yarn sales segment is due to the penetration of new markets, particularly the craft yarn category.

The Company's dollar value of incoming orders during the first half of 2004 decreased approximately 10.4% compared to the first half of 2003. The dollar value of the backlog decreased by approximately 11.9%, to $21.6 million at the end of the first half of 2004 as compared to $24.5 million at the end of the same period in 2003, with the dollar value of the fabric backlog down 21.3% and the dollar value of the yarn backlog up 143.3%.

The gross profit margin for the first half of both 2003 and 2004 was 20.4%. The improvement in the gross margin in the first quarter of 2004 was offset primarily by higher fixed unit costs in the second quarter of 2004.

Selling, general and administrative expenses decreased to $27.4 million in the first half of 2004 from $27.5 million in the first half of 2003. Lower costs were incurred in the first half of 2004 as compared to the first half of 2003 in several semi-variable expense categories, such as expenditures for research and development and advertising expenses. Selling, general and administrative expenses as a percentage of net sales increased to 17.4% in the first half of 2004 from 16.8% in the first half of 2003. This increase as a percentage of net sales was due to lower net sales in the first half of 2004 compared to the same period in 2003.

Interest expense was $1.7 million for the first half of 2004 and $2.1 million for the first half of 2003. Lower levels of both variable and fixed rate debt in the first half of 2004 resulted in the decline in interest expense.

The Company provides for income taxes on an interim basis, using an estimated annual effective income tax rate. The Company's estimated tax rate was 35.4% for 2003 and 36.5% for the first quarter of 2004. The Company has adjusted the estimated annual effective tax rate for 2004 downward to 35.5%. This reduction in the tax rate is due to lower levels of projected income for 2004 reducing the effective statutory federal income tax rate from 35% to approximately 34% and an increased estimated benefit to the tax rate from the Extraterritorial Income Exclusion. The effective income tax rate is lower than the combined federal and state statutory rates, due primarily to certain tax benefits related to extraterritorial income at the federal level and investment tax credits at the state level.

The Company is currently challenging tax assessments from the Internal Revenue Service for the years 1997-1999 and from the Massachusetts Department of Revenue for the years 1993-1998. In addition, during the third quarter of Fiscal 2003 the Company filed amended tax returns for these and subsequent years to claim approximately $3.5 million of federal and state research and development credits. Audits of these amended returns commenced during October 2003. There is significant uncertainty surrounding the amount and timing of the benefit that will be ultimately realized. The Company believes that it has a supportable basis for claiming these credits, but the amounts are subject to ongoing audits by federal and state authorities. Accordingly, the Company has not reflected the potential benefits of these credits in its financial statements for these or subsequent years. No benefit will be recognized in the financial statements until these gain contingencies are resolved through the eventual disposition with the respective tax authorities.

Net income for the first half of 2004 decreased to $2.0 million or $0.11 per common share-diluted, from $2.5 million or $0.15 per common share-diluted for the first half of 2003.

Liquidity and Capital Resources

The Company historically has financed its operations and capital requirements through a combination of internally generated funds, borrowings under the Credit Agreement (as hereinafter defined), and debt and equity offerings. The Company's capital requirements have arisen principally in connection with (i) the purchase of equipment to expand production capacity, introduce new technologies to broaden and differentiate the Company's products, and improve the Company's quality and productivity performance, (ii) increases in the Company's working capital needs related to its sales growth, and (iii) investments in the Company's information technology systems.

The primary source of the Company's liquidity and capital resources in recent years has been operating cash flow. The Company's net cash provided by operating activities was $11.4 million and $17.7 million in the first six months of 2004 and 2003, respectively. Cash provided by operating activities decreased during 2004 primarily due to changes in working capital. As necessary, the Company supplements its operating cash flow with borrowings. Net debt repayments were $0.0 million in the first six months of 2004 and $13.7 million in the first six months of 2003.

Capital expenditures in the first six months of 2004 and 2003 were $7.9 million and $3.8 million, respectively. Capital expenditures during the first six months of 2004 were funded by operating cash flow. Management anticipates that capital expenditures for new projects will total approximately $15.7 million in 2004, consisting of approximately $11.5 million for various manufacturing equipment, $2.1 million for IT projects, and $2.1 million for various other capital projects. Management believes that cash on hand, operating income and borrowings under the Credit Agreement (as hereinafter defined) will provide sufficient funding for the Company's capital expenditures and working capital needs for the foreseeable future.

On July 2, 2004, the Company entered into a purchase and sale agreement to acquire for $21.0 million a single story industrial building located on 33.6 acres of land in Fall River, Massachusetts. The Company anticipates that it may utilize borrowings under the Credit Agreetment as the initial source of the funds to complete the transaction, but that it will also review alternative financing strategies, which may include the designation of an unrelated third party to take title to the property which would then be leased to Quaker. Completion of the

purchase or long-term lease of this facility is anticipated during the fourth quarter of 2004. By the end of 2005, the Company plans to have moved four of the manufacturing and warehousing operations currently being conducted in leased facilities into this new facility. The Company anticipates that it will incur a short-term increase in operating expenses of approximately $2.1 million during the transition to this new facility. Approximately $1.6 million will be moving and lease termination costs and another $0.5 million attributable to the duplication of certain facilities-related expenses.

The Company issued $45.0 million of Senior Notes due October 2005 and 2007 (the Senior Notes) during 1997. The Senior Notes are unsecured and bear interest at a fixed rate of 7.09% on $15.0 million and 7.18% on $30.0 million. The Senior Notes may be prepaid in whole or in part prior to maturity, at the Company's option, subject to a yield maintenance premium, as defined. Annual principal payments began on October 10, 2003 with a final payment due October 10, 2007. Annual principal payment amounts are three payments of $5.0 million beginning in October 2003, followed by two payments of $15.0 million beginning in 2006.

On February 14, 2002, the Company issued $5.0 million of 7.56% Series A Notes due February 2009 (the "Series A Notes"). The Series A Notes are unsecured and bear interest at a fixed rate of 7.56%, payable semiannually. The Series A Notes may be prepaid in whole or in part prior to maturity, at the Company's option, subject to a yield maintenance premium, as defined. In addition and also on February 14, 2002, the Company entered into a $45.0 million non-committed Shelf Note agreement with an insurance company pursuant to which the Company may issue additional senior notes prior to February 14, 2005 with maturity dates of up to ten years.

The Company also has a $60.0 million Credit Agreement with a bank which expires January 31, 2007 (the Credit Agreement). As of July 3, 2004, the Company had no loans outstanding under the Credit Agreement and unused availability of $59.7 million. See Note 5 of Notes to Consolidated Financial Statements included in the Company's 2003 Annual Report on Form 10-K.

The Company is required to comply with a number of affirmative and negative convenants under the Credit Agreement, the Senior Notes, and the Series A Notes, including, but not limited to, maintenance of certain financial tests and ratios (including interest coverage ratios, net worth related ratios, and net worth requirements); limitations on certain business activities of the Company; restrictions on the Company's ability to declare and pay dividends, incur additional indebtedness, create certain liens, incur capital lease obligations, make certain investments, engage in certain transactions with stockholders and affiliates, and purchase, merge, or consolidate with or into any other corporation. The Company is currently in compliance with all the affirmative and negative convenants in the Credit Agreement, the Series A Notes, and the Senior Notes and management believes the Company's continued compliance will not prevent the Company from operating in the normal course of business.

No dividends were paid on the Company's common stock prior to Fiscal 2003. During the first quarter of 2003, the Board of Directors adoped a new dividend policy. This policy provides for future dividends to be declared at the discretion of the Board of Directors, based on the Board's quarterly evaluation of the Company's results of operations, cash requirements, financial conditions and other factors deemed relevant by the Board. In the first half of 2004 and 2003, the Company paid cash dividends of $1.0 million or $0.06 per common share and $0.8 million or $0.05 per common share, respectively. On July 22, 2004, the Board of Directors declared a cash dividend of $0.03 per common share payable on August 18, 2004 to shareholders of record on August 4, 2004.

Inflation

The Company does not believe that inflation has had a significant impact on the Company's results of operations for the periods presented. Historically, the Company believes it has been able to minimize the effects of inflation by improving its manufacturing and purchasing efficiency, by increasing employee productivity, and by reflecting the effects of inflation in the selling prices of the new products it introduces each year.

Cautionary Statement Regarding Forward-Looking Information

Statements contained in this report, as well as oral statements made by the Company that are prefaced by the words "may," "will," "expect," "anticipate," "continue," "estimate," "project," "intend," "designed" and similar expressions, are intended to identify forward-looking statements regarding events, conditions and financial trends that may affect the Company's future plans of operations, business strategy, results of operations and financial position. These statements are based on the Company's current expectations and estimates as to prospective events and circumstances about which the Company can give no firm assurance. Further, any forward-looking statement speaks only as of the date on which such statement is made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made. As it is not possible to predict every new factor that may emerge, forward-looking statements should not be relied upon as a prediction of the Company's actual future financial condition or results. These forward-looking statements, like any forward-looking statements, involve risks and uncertainties that could cause actual results to differ materially from those projected or anticipated. Such risks and uncertainties include product demand and market acceptance of the Company's products, regulatory uncertainties, the Company's ability to comply in a timely manner with the rules and regulations set forth in the Sarbanes-Oxley Act, the effect of economic conditions, the impact of competitive products and pricing, foreign currency exchange rates, changes in customer ordering patterns, and the effect of uncertainties in markets outside the U.S. (including Mexico and South America) in which the Company operates.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Derivative Financial Instruments, Other Financial Instruments, and Derivative Commodity Instruments

Quantitative and Qualitative Disclosures About Market Risk

The Company's exposures relative to market risk are due to foreign exchange risk and interest rate risk.

Foreign currency risk

Approximately 2.5% of the Company's revenues are generated outside the

U.S. from sales which are not denominated in U.S. dollars. Foreign currency risk arises because the Company engages in business in certain foreign countries in local currency. Accordingly, in the absence of hedging activities, whenever the U.S. dollar strengthens relative to the other major currencies, there is an adverse affect on the Company's results of operations, and alternatively, whenever the U.S. dollar weakens relative to the other major currencies, there is a positive affect on the Company's results of operations.

It is the Company's policy to minimize, for a period of time, the unforeseen impact on its results of operations of fluctuations in foreign exchange rates by using derivative financial instruments to hedge the fair value of foreign currency denominated intercompany payables. The Company's primary foreign currency exposures in relation to the U.S. dollar are the Mexican peso and the Brazilian real.

At July 3, 2004, the Company had the following derivative financial instruments to hedge the anticipated cash flows from the repayment of foreign currency denominated intercompany payables outstanding:

Type of Instrument	Currency	Notional Amount in Local Currency	Weighted Average Contract Rate	Notional Amount in U.S. Dollars	Fair Value Gain (Losses)	Maturity
Type of Instrument						
Forward Contracts	Mexican Peso	28.0 million	11.46	$2.4 million	$ 42,000	Jan. 2005
Capped Forward Options	Mexican Peso	44.0 million	11.52	$3.8 million	$103,000	Dec. 2005
Forward Contracts	Brazilian Real	0.6 million	3.20	$0.2 million	$ (5,000)	Oct. 2004

The Capped Forward Options are agreements to sell Mexican pesos at the fixed rate of 11.52, as long as the spot rate at the maturity of each contract is 12.70 or less.

The Company occasionally purchases manufacturing equipment at prices which are denominated in foreign currencies. The Company hedges these purchases by purchasing forward contracts at the time the purchase commitment is made. As of July 3, 2004, the Company had entered into forward contracts to purchase 1.5 million Euros (USD $1.2 million) at an average rate of 1.22. The fair value of these contracts was $8,000 as of July 3, 2004.

Interest Rate Risk

All of the Company's outstanding long-term debt is at fixed rates. Accordingly, a change in prevailing interest rates has an insignificant effect on the Company's interest expense. The fair value of the Company's long-term debt, however, would change in response to interest rate movements due to its fixed rate nature.

The Company has evaluated the impact on all long-term maturities of changing the interest rate 10% from the rate levels that existed at July 3, 2004 and has determined that such a rate change would not have a material impact on the Company.

Item 4. CONTROLS AND PROCEDURES

The Company's management, under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, management has concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective in alerting them on a timely basis to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic filings under the Exchange Act. In addition, management has evaluated and concluded that during the most recent fiscal quarter covered by this report, there has not been any change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

QUAKER FABRIC CORPORATION AND SUBSIDIARIES

PART II - OTHER INFORMATION

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

On May 21, 2004, an annual meeting of the shareholders of the Company was held at which directors were elected to serve until their successors shall have been elected and shall have qualified and the Quaker Fabric Corporation 2004 Stock Incentive Plan was approved. The number of votes cast for, against, or withheld/abstained and the number of broker non-votes with regard to each nominee or matter are set forth below:

	For	Against	Withheld Abstained	Broker Non-Votes
Election of directors:				
Sangwoo Ahn	14,797,904	N/A	1,033,897	N/A
Larry A. Liebenow	14,941,016	N/A	890,785	N/A
Jerry I. Porras	14,995,706	N/A	836,095	N/A
Eriberto R. Scocimara	14,888,704	N/A	943,097	N/A
Approval of the Quaker Fabric Corporation 2004 Stock Incentive Plan	11,842,281	1,393,095	113,831	2,482,603

Item 6. Exhibits and Reports on Form 8-K

(A) Exhibits

31.1 Certification by the Chief Executive Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification by the Chief Financial Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification by the Chief Executive Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification by the Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

(B) The Company filed a report on Form 8-K on April 19, 2004, in which the Company furnished a press release announcing its first quarter results for the period ending April 3, 2004.

QUAKER FABRIC CORPORATION AND SUBSIDIARIES

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.

QUAKER FABRIC CORPORATION

Date: August 11, 2004 By: /s/ Paul J. Kelly

Paul J. Kelly
Vice President - Finance
and Treasurer (Principal Financial Officer)

EXHIBIT 31.1

CERTIFICATION

I, Larry A. Liebenow, certify that:

1. I have reviewed this report on Form 10-Q of Quaker Fabric Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:

    a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    b. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    c. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial

reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ Larry A. Liebenow

Larry A. Liebenow

Chief Executive Officer

Date: August 11, 2004

EXHIBIT 31.2

CERTIFICATION

I, Paul J. Kelly, certify that:

1. I have reviewed this report on Form 10-Q of Quaker Fabric Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:

    a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    b. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    c. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial

reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:

a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ Paul J. Kelly

Paul J. Kelly

Chief Financial Officer

Date: August 11, 2004

EXHIBIT 32.1

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350

In connection with this quarterly report on Form 10-Q of Quaker Fabric Corporation for the quarterly period ended July 3, 2004 (the "Periodic Report"), I, Larry A. Liebenow, Chief Executive Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Periodic Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 11, 2004

/s/ Larry A. Liebenow

Larry A. Liebenow
Chief Executive Officer

This certification is being furnished as an exhibit to the Report pursuant to Exchange Act Rule 13a-14 and Item 601 of Regulation S-K and 18 United States Code Section 1350 and not as a document "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section. This certificate shall not be deemed incorporated by reference into any of the Company's filings under the Securities Act or the Exchange Act, except to the extent the Company specifically incorporates it by reference.

EXHIBIT 32.2

CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350

In connection with this quarterly report on Form 10-Q of Quaker Fabric Corporation for the quarterly period ended July 3, 2004 (the "Periodic Report"), I, Paul J. Kelly, Chief Financial Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Periodic Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that the information contained in the Periodic Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 11, 2004

/s/ Paul J. Kelly

Paul J. Kelly
Chief Financial Officer

This certification is being furnished as an exhibit to the Report pursuant to Exchange Act Rule 13a-14 and Item 601 of Regulation S-K and 18 United States Code Section 1350 and not as a document "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section. This certificate shall not be deemed incorporated by reference into any of the Company's filings under the Securities Act or the Exchange Act, except to the extent the Company specifically incorporates it by reference.