

DIXIE GROUP INC  
Form 10-Q  
August 08, 2012

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2012

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-2585

THE DIXIE GROUP, INC.

(Exact name of Registrant as specified in its charter)

Tennessee

62-0183370

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

104 Nowlin Lane, Suite 101, Chattanooga, TN 37421

(423) 510-7000

(Address of principal executive offices) (zip code)

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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 ☐ No

Indicate by check mark whether the registrant has submitted electronically and posted on its Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☐ Yes ☐ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act.) ☐ Yes ☒ No

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The number of shares outstanding of each of the issuer's classes of Common Stock as of the latest practicable date.

| Class                               | Outstanding as of July 23, 2012 |
|-------------------------------------|---------------------------------|
| Common Stock, \$3 Par Value         | 12,156,590 shares               |
| Class B Common Stock, \$3 Par Value | 952,784 shares                  |
| Class C Common Stock, \$3 Par Value | 0 shares                        |

THE DIXIE GROUP, INC.

Table of Contents

|                                                                                                                                                             |           |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------|
| PART I. FINANCIAL INFORMATION                                                                                                                               | Page      |
| Item 1. <u>Financial Statements</u>                                                                                                                         | <u>3</u>  |
| <u>Consolidated Condensed Balance Sheets - June 30, 2012 (Unaudited) and December 31, 2011</u>                                                              | <u>3</u>  |
| <u>Consolidated Condensed Statements of Operations - Three and Six Months Ended June 30, 2012 (Unaudited) and July 2, 2011 (Unaudited)</u>                  | <u>4</u>  |
| <u>Consolidated Condensed Statements of Comprehensive Income (Loss) - Three and Six Months Ended June 30, 2012 (Unaudited) and July 2, 2011 (Unaudited)</u> | <u>5</u>  |
| <u>Consolidated Condensed Statements of Cash Flows - Six Months Ended June 30, 2012 (Unaudited) and July 2, 2011 (Unaudited)</u>                            | <u>6</u>  |
| <u>Notes to Consolidated Condensed Financial Statements (Unaudited)</u>                                                                                     | <u>7</u>  |
| Item 2. <u>Management's Discussion and Analysis of Results of Operations and Financial Condition</u>                                                        | <u>18</u> |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>                                                                                   | <u>22</u> |
| Item 4. <u>Controls and Procedures</u>                                                                                                                      | <u>22</u> |
| PART II. OTHER INFORMATION                                                                                                                                  |           |
| Item 1. <u>Legal Proceedings</u>                                                                                                                            | <u>23</u> |
| Item 1A. <u>Risk Factors</u>                                                                                                                                | <u>23</u> |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                                                                                  | <u>24</u> |
| Item 3. <u>Defaults Upon Senior Securities</u>                                                                                                              | <u>25</u> |
| Item 4. <u>Mine Safety Disclosures</u>                                                                                                                      | <u>25</u> |
| Item 5. <u>Other information</u>                                                                                                                            | <u>25</u> |
| Item 6. <u>Exhibits</u>                                                                                                                                     | <u>25</u> |
| <u>Signatures</u>                                                                                                                                           | <u>26</u> |

## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## THE DIXIE GROUP, INC.

## CONSOLIDATED CONDENSED BALANCE SHEETS

(dollars in thousands, except share data)

|                                                                                                                                            | June 30,<br>2012<br>(Unaudited) | December 31,<br>2011 |
|--------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|----------------------|
| <b>ASSETS</b>                                                                                                                              |                                 |                      |
| <b>CURRENT ASSETS</b>                                                                                                                      |                                 |                      |
| Cash and cash equivalents                                                                                                                  | \$240                           | \$298                |
| Receivables, net                                                                                                                           | 30,850                          | 29,173               |
| Inventories                                                                                                                                | 72,940                          | 63,939               |
| Deferred income taxes                                                                                                                      | 5,291                           | 5,860                |
| Other current assets                                                                                                                       | 2,074                           | 1,729                |
| <b>TOTAL CURRENT ASSETS</b>                                                                                                                | <b>111,395</b>                  | <b>100,999</b>       |
| <br><b>PROPERTY, PLANT AND EQUIPMENT</b>                                                                                                   | <br><b>185,536</b>              | <br><b>183,816</b>   |
| Less accumulated depreciation and amortization                                                                                             | (120,926)                       | (116,275)            |
| <b>NET PROPERTY, PLANT AND EQUIPMENT</b>                                                                                                   | <b>64,610</b>                   | <b>67,541</b>        |
| <b>OTHER ASSETS</b>                                                                                                                        | <b>14,139</b>                   | <b>14,403</b>        |
| <b>TOTAL ASSETS</b>                                                                                                                        | <b>\$190,144</b>                | <b>\$182,943</b>     |
| <br><b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                            |                                 |                      |
| <b>CURRENT LIABILITIES</b>                                                                                                                 |                                 |                      |
| Accounts payable                                                                                                                           | \$16,575                        | \$14,668             |
| Accrued expenses                                                                                                                           | 16,495                          | 17,185               |
| Current portion of long-term debt                                                                                                          | 2,227                           | 2,729                |
| <b>TOTAL CURRENT LIABILITIES</b>                                                                                                           | <b>35,297</b>                   | <b>34,582</b>        |
| <br><b>LONG-TERM DEBT</b>                                                                                                                  |                                 |                      |
| Senior indebtedness                                                                                                                        | 60,732                          | 52,806               |
| Mortgage note payable                                                                                                                      | 9,772                           | 10,141               |
| Equipment notes payable                                                                                                                    | 2,034                           | 2,061                |
| Capital lease obligations                                                                                                                  | 800                             | 349                  |
| <b>TOTAL LONG-TERM DEBT</b>                                                                                                                | <b>73,338</b>                   | <b>65,357</b>        |
| <br><b>DEFERRED INCOME TAXES</b>                                                                                                           | <br><b>3,687</b>                | <br><b>4,804</b>     |
| <b>OTHER LONG-TERM LIABILITIES</b>                                                                                                         | <b>13,941</b>                   | <b>13,815</b>        |
| <b>TOTAL LIABILITIES</b>                                                                                                                   | <b>126,263</b>                  | <b>118,558</b>       |
| <br><b>COMMITMENTS AND CONTINGENCIES</b>                                                                                                   | <br><b>—</b>                    | <br><b>—</b>         |
| <br><b>STOCKHOLDERS' EQUITY</b>                                                                                                            |                                 |                      |
| Common Stock (\$3 par value per share): Authorized 80,000,000 shares, issued - 16,170,030 shares for 2012 and 15,998,937 shares for 2011   | 48,510                          | 47,997               |
| Class B Common Stock (\$3 par value per share): Authorized 16,000,000 shares, issued - 952,784 shares for 2012 and 882,644 shares for 2011 | 2,858                           | 2,648                |
| Additional paid-in capital                                                                                                                 | 137,825                         | 138,118              |

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|                                                                                                 |           |   |           |   |
|-------------------------------------------------------------------------------------------------|-----------|---|-----------|---|
| Accumulated deficit                                                                             | (66,378   | ) | (65,764   | ) |
| Accumulated other comprehensive loss                                                            | (254      | ) | (88       | ) |
|                                                                                                 | 122,561   |   | 122,911   |   |
| Less Common Stock in treasury at cost - 4,013,440 shares for 2012 and 3,976,396 shares for 2011 | (58,680   | ) | (58,526   | ) |
| TOTAL STOCKHOLDERS' EQUITY                                                                      | 63,881    |   | 64,385    |   |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY                                                      | \$190,144 |   | \$182,943 |   |
| See accompanying notes to the consolidated condensed financial statements.                      |           |   |           |   |

Table of Contents

3

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## THE DIXIE GROUP, INC.

## CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS

(UNAUDITED)

(dollars in thousands, except per share data)

|                                                       | Three Months Ended |          | Six Months Ended |           |
|-------------------------------------------------------|--------------------|----------|------------------|-----------|
|                                                       | June 30,           | July 2,  | June 30,         | July 2,   |
|                                                       | 2012               | 2011     | 2012             | 2011      |
| NET SALES                                             | \$66,566           | \$69,200 | \$129,416        | \$135,154 |
| Cost of sales                                         | 50,847             | 52,477   | 97,995           | 101,861   |
| GROSS PROFIT                                          | 15,719             | 16,723   | 31,421           | 33,293    |
| Selling and administrative expenses                   | 15,683             | 14,944   | 30,745           | 30,337    |
| Other operating (income) expense, net                 | 76                 | 42       | 96               | (450)     |
| Facility consolidation and severance expenses, net    | —                  | (563)    | —                | (563)     |
| OPERATING INCOME (LOSS)                               | (40)               | 2,300    | 580              | 3,969     |
| Interest expense                                      | 762                | 900      | 1,488            | 1,832     |
| Other (income) expense, net                           | (95)               | 10       | (92)             | (6)       |
| INCOME (LOSS) FROM CONTINUING OPERATIONS BEFORE TAXES | (707)              | 1,390    | (816)            | 2,143     |
| Income tax provision (benefit)                        | (303)              | 582      | (308)            | 691       |
| INCOME (LOSS) FROM CONTINUING OPERATIONS              | (404)              | 808      | (508)            | 1,452     |
| Loss from discontinued operations, net of tax         | (29)               | (42)     | (106)            | (62)      |
| NET INCOME (LOSS)                                     | \$(433)            | \$766    | \$(614)          | \$1,390   |
| BASIC EARNINGS (LOSS) PER SHARE:                      |                    |          |                  |           |
| Continuing operations                                 | \$(0.03)           | \$0.06   | \$(0.04)         | \$0.11    |
| Discontinued operations                               | —                  | —        | (0.01)           | —         |
| Net income (loss)                                     | \$(0.03)           | \$0.06   | \$(0.05)         | \$0.11    |
| BASIC SHARES OUTSTANDING                              | 12,633             | 12,596   | 12,619           | 12,574    |
| DILUTED EARNINGS (LOSS) PER SHARE:                    |                    |          |                  |           |
| Continuing operations                                 | \$(0.03)           | \$0.06   | \$(0.04)         | \$0.11    |
| Discontinued operations                               | —                  | —        | (0.01)           | —         |
| Net income (loss)                                     | \$(0.03)           | \$0.06   | \$(0.05)         | \$0.11    |
| DILUTED SHARES OUTSTANDING                            | 12,633             | 12,648   | 12,619           | 12,624    |
| DIVIDENDS PER SHARE:                                  |                    |          |                  |           |
| Common Stock                                          | —                  | —        | —                | —         |
| Class B Common Stock                                  | —                  | —        | —                | —         |

See accompanying notes to the consolidated condensed financial statements.

[Table of Contents](#)

## THE DIXIE GROUP, INC.

## CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(UNAUDITED)

(dollars in thousands)

|                                                                                              | Three Months Ended |         | Six Months Ended |           |
|----------------------------------------------------------------------------------------------|--------------------|---------|------------------|-----------|
|                                                                                              | June 30,           | July 2, | June 30,         | July 2,   |
|                                                                                              | 2012               | 2011    | 2012             | 2011      |
| NET INCOME (LOSS)                                                                            | \$(433             | ) \$766 | \$(614           | ) \$1,390 |
| OTHER COMPREHENSIVE INCOME (LOSS),<br>NET OF TAX:                                            |                    |         |                  |           |
| Unrealized loss on interest rate swaps                                                       | (241               | ) (161  | ) (321           | ) (132    |
| Reclassification of loss into earnings from interest<br>rate swaps                           | 24                 | 85      | 48               | 172       |
| Amortization of unrealized loss on dedesignated<br>interest rate swaps                       | 73                 | —       | 147              | —         |
| Reclassification of net actuarial gain into earnings<br>from postretirement benefit plans    | (6                 | ) (4    | ) (12            | ) (9      |
| Reclassification of prior service credits into earnings<br>from postretirement benefit plans | (14                | ) (14   | ) (28            | ) (28     |
| TOTAL OTHER COMPREHENSIVE INCOME<br>(LOSS), NET OF TAX                                       | (164               | ) (94   | ) (166           | ) 3       |
| COMPREHENSIVE INCOME (LOSS)                                                                  | \$(597             | ) \$672 | \$(780           | ) \$1,393 |
| See accompanying notes to the consolidated condensed financial statements.                   |                    |         |                  |           |

[Table of Contents](#)

5

THE DIXIE GROUP, INC.  
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS  
(UNAUDITED)  
(dollars in thousands)

|                                                                                      | Six Months Ended |                  |
|--------------------------------------------------------------------------------------|------------------|------------------|
|                                                                                      | June 30,<br>2012 | July 2,<br>2011  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                          |                  |                  |
| Income (loss) from continuing operations                                             | \$(508)          | ) \$1,452        |
| Loss from discontinued operations                                                    | (106)            | ) (62)           |
| Net income (loss)                                                                    | (614)            | ) 1,390          |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: |                  |                  |
| Depreciation and amortization                                                        | 4,782            | 4,879            |
| Change in deferred income taxes                                                      | (446)            | ) 530            |
| Net gain on property, plant and equipment disposals                                  | —                | (2)              |
| Stock-based compensation expense                                                     | 415              | 373              |
| Excess tax benefits from stock-based compensation                                    | (16)             | ) —              |
| Changes in operating assets and liabilities:                                         |                  |                  |
| Receivables                                                                          | (1,677)          | ) (1,995)        |
| Inventories                                                                          | (9,001)          | ) (10,464)       |
| Other current assets                                                                 | (345)            | ) (2,263)        |
| Accounts payable and accrued expenses                                                | 1,326            | 3,043            |
| Other operating assets and liabilities                                               | 12               | (1,181)          |
| <b>NET CASH USED IN OPERATING ACTIVITIES</b>                                         | <b>(5,564)</b>   | <b>) (5,690)</b> |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                          |                  |                  |
| Net proceeds from sales of property, plant and equipment                             | —                | 2                |
| Purchase of property, plant and equipment                                            | (1,058)          | ) (2,140)        |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>                                         | <b>(1,058)</b>   | <b>) (2,138)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                          |                  |                  |
| Net borrowings on previous credit line                                               | —                | 12,509           |
| Payments on previous term loan                                                       | —                | (879)            |
| Net borrowings on current credit line                                                | 7,926            | —                |
| Payments on current mortgage note payable                                            | (369)            | ) —              |
| Payments on previous mortgage note payable                                           | —                | (176)            |
| Borrowings on equipment financing                                                    | 469              | —                |
| Payments on equipment financing                                                      | (668)            | ) (1,315)        |
| Payments on capitalized leases                                                       | (56)             | ) (204)          |
| Payments on notes payable                                                            | (454)            | ) (374)          |
| Payments on subordinated indebtedness                                                | —                | (2,500)          |
| Change in outstanding checks in excess of cash                                       | (93)             | ) 801            |
| Common stock acquired for treasury                                                   | (154)            | ) (127)          |
| Excess tax benefits from stock-based compensation                                    | 16               | —                |
| Payments for debt issuance costs                                                     | (53)             | ) —              |
| <b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>                                     | <b>6,564</b>     | <b>7,735</b>     |
| <b>DECREASE IN CASH AND CASH EQUIVALENTS</b>                                         | <b>(58)</b>      | <b>) (93)</b>    |

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|                                                  |       |       |
|--------------------------------------------------|-------|-------|
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 298   | 244   |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD       | \$240 | \$151 |

Supplemental Cash Flow Information:

|                                          |         |         |
|------------------------------------------|---------|---------|
| Interest paid                            | \$1,326 | \$1,887 |
| Income taxes paid, net of tax refunds    | 1,229   | 91      |
| Equipment purchased under capital leases | 631     | —       |

See accompanying notes to the consolidated condensed financial statements.

Table of Contents

6

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THE DIXIE GROUP, INC.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data)

NOTE A - BASIS OF PRESENTATION

The accompanying unaudited consolidated condensed financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements which do not include all the information and footnotes required by such accounting principles for annual financial statements. In the opinion of management, all adjustments (generally consisting of normal recurring accruals) considered necessary for a fair presentation have been included in the accompanying financial statements. The accompanying financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission for the fiscal year ended December 31, 2011. Operating results for the three and six month periods ended June 30, 2012 are not necessarily indicative of the results that may be expected for the entire 2012 year. The six months ended June 30, 2012 contains 26 weeks compared with 27 weeks for the six months ended July 2, 2011.

The Company evaluated subsequent events through the date the financial statements were issued.

The Company is in one line of business, carpet manufacturing.

NOTE B - RECENT ACCOUNTING PRONOUNCEMENTS

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. This ASU represents the converged guidance of the FASB and the International Accounting Standards Board ("the Boards") on fair value measurement. The collective efforts of the Boards and their staffs have resulted in common requirements, including a consistent meaning of the term "fair value." The Boards have concluded the common requirements will result in greater comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and IFRS. The ASU was effective during the first quarter of 2012 and its adoption did not have a material effect on the Company's Consolidated Condensed Financial Statements.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. This ASU eliminates the option to report other comprehensive income and its components in the statement of stockholders equity and requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The Company early adopted this ASU in the prior year and presented the components of other comprehensive income in a separate statement following the statement of operations. In December 2011, the FASB issued ASU 2011-12, Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. ASU 2011-12 deferred the changes in ASU 2011-05 that relate to the presentation of reclassification adjustments to other comprehensive income. These amendments were delayed to allow the FASB time to redeliberate whether to present the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income on the face of the financial statements for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification

adjustments, the Company is required to continue reporting reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05.

In December 2011, the FASB issued ASU No. 2011-11, "Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities." The amendments in this ASU require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The Company does not expect that the adoption of this ASU will have a a material effect on the Company's Consolidated Condensed Financial Statements.

#### NOTE C - STOCK COMPENSATION EXPENSE

The Company recognizes compensation expense relating to share-based payments based on the fair value of the equity instrument issued and records such expense in selling and administrative expenses in the Company's Consolidated Condensed Financial Statements. The number of shares to be issued is determined by dividing the specified dollar value of the award by the market value per share on the grant date. Pursuant to a policy adopted by the Compensation Committee of the Board of Directors applicable to awards granted for years 2009 through 2012, \$5.00 per share will be used as the market value per share

#### Table of Contents

## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

to calculate the number of shares to be issued if the market value per share is less than \$5.00 per share on the grant date. The Company's stock compensation expense was \$256 and \$415 for the three and six months ended June 30, 2012, respectively, and \$200 and \$373 for the three and six months ended July 2, 2011, respectively.

On March 12, 2012, the Company issued 241,233 shares of restricted stock to officers and other key employees. The grant-date fair value of the awards was \$998, or \$4.135 per share, and will be recognized as stock compensation expense over the vesting periods which range from 2 to 15 years from the date the awards were granted. Each award is subject to a continued service condition. The fair value of each share of restricted stock awarded was equal to the market value of a share of the Company's Common Stock on the grant date.

## NOTE D - RECEIVABLES, NET

Receivables are summarized as follows:

|                                      | June 30,<br>2012 | December 31,<br>2011 |
|--------------------------------------|------------------|----------------------|
| Customers, trade                     | \$30,390         | \$28,372             |
| Other receivables                    | 1,038            | 1,268                |
| Gross receivables                    | 31,428           | 29,640               |
| Less allowance for doubtful accounts | (578)            | (467)                |
| Net receivables                      | \$30,850         | \$29,173             |

The Company had notes receivable in the amount of \$476 and \$483 at June 30, 2012 and December 31, 2011, respectively. The current portions of notes receivable are included in other receivables above and the non-current portions are included in other assets in the Company's Consolidated Condensed Financial Statements.

## NOTE E - INVENTORIES

Inventories are stated at the lower of cost or market. Cost is determined using the last-in, first-out (LIFO) method, which generally matches current costs of inventory sold with current revenues, for substantially all inventories.

Inventories are summarized as follows:

|                                  | June 30,<br>2012 | December 31,<br>2011 |
|----------------------------------|------------------|----------------------|
| Raw materials                    | \$24,252         | \$19,624             |
| Work-in-process                  | 14,295           | 13,116               |
| Finished goods                   | 49,236           | 45,840               |
| Supplies, repair parts and other | 453              | 351                  |
| LIFO reserve                     | (15,296)         | (14,992)             |
| Total inventories                | \$72,940         | \$63,939             |

## NOTE F - ACCRUED EXPENSES

Accrued expenses are summarized as follows:

| June 30,<br>2012 | December 31,<br>2011 |
|------------------|----------------------|
|------------------|----------------------|

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|                                                       |          |          |
|-------------------------------------------------------|----------|----------|
| Compensation and benefits                             | \$3,897  | \$4,348  |
| Provision for customer rebates, claims and allowances | 4,364    | 4,249    |
| Outstanding checks in excess of cash                  | 2,635    | 2,728    |
| Other                                                 | 5,599    | 5,860    |
| Total accrued expenses                                | \$16,495 | \$17,185 |

Table of Contents

8

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## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

## NOTE G - PRODUCT WARRANTY RESERVES

The Company generally provides product warranties related to manufacturing defects and specific performance standards for its products. At the time sales are recorded, the Company records reserves for the estimated costs of defective products and failure of its products to meet applicable performance standards. The level of reserves the Company establishes is based primarily upon historical experience, including the level of sales and evaluation of pending claims. Product warranty reserves are included in accrued expenses in the Company's Consolidated Condensed Financial Statements. The following is a summary of the Company's product warranty activity.

|                                               | Three Months Ended |         | Six Months Ended |         |
|-----------------------------------------------|--------------------|---------|------------------|---------|
|                                               | June 30,           | July 2, | June 30,         | July 2, |
|                                               | 2012               | 2011    | 2012             | 2011    |
| Warranty reserve at beginning of period       | \$1,106            | \$1,449 | \$1,219          | \$1,472 |
| Warranty liabilities accrued                  | 804                | 828     | 1,546            | 1,613   |
| Warranty liabilities settled                  | (760)              | (813)   | (1,627)          | (1,581) |
| Changes for pre-existing warranty liabilities | 58                 | (216)   | 70               | (256)   |
| Warranty reserve at end of period             | \$1,208            | \$1,248 | \$1,208          | \$1,248 |

## NOTE H - LONG-TERM DEBT AND CREDIT ARRANGEMENTS

Long-term debt consists of the following:

|                                            | June 30,<br>2012 | December 31,<br>2011 |
|--------------------------------------------|------------------|----------------------|
| Senior indebtedness                        | \$60,732         | \$52,806             |
| Mortgage note payable                      | 10,509           | 10,878               |
| Equipment notes payable                    | 3,156            | 3,354                |
| Notes payable                              | 129              | 584                  |
| Capital lease obligations                  | 1,039            | 464                  |
| Total long-term debt                       | 75,565           | 68,086               |
| Less: current portion of long-term debt    | (2,227)          | (2,729)              |
| Total long-term debt, less current portion | \$73,338         | \$65,357             |

## Senior indebtedness

On September 14, 2011, the Company entered into a five-year, secured revolving credit facility (the "senior credit facility"). The senior credit facility provides for a maximum of \$90,000 of revolving credit, subject to borrowing base availability, including limited amounts of credit in the form of letters of credit and swingline loans. The borrowing base is equal to specified percentages of the Company's eligible accounts receivable, inventories and fixed assets less reserves established, from time to time, by the administrative agent under the senior credit facility.

At the Company's election, revolving loans under the senior credit facility bear interest at annual rates equal to either (a) LIBOR for 1, 2 or 3 month periods, as selected by the Company, plus an applicable margin of either 2.00% or 2.25%, or (b) the higher of the prime rate, the Federal Funds rate plus 0.5%, or a daily LIBOR rate, plus an applicable margin of either 1.00% or 1.50%. The applicable margin is determined based on availability under the senior credit

facility with margins increasing as availability decreases. The Company also pays an unused line fee on the average amount by which the aggregate commitments exceed utilization of the senior credit facility equal to 0.375% per annum.

The senior credit facility includes certain affirmative and negative covenants that impose restrictions on the Company's financial and business operations, including limitations on debt, liens, investments, fundamental changes in the Company's business, asset dispositions, dividends and other similar restricted payments, transactions with affiliates, payments and modifications of certain existing debt, future negative pledges, and changes in the nature of the Company's business. The Company is also required to maintain a fixed charge coverage ratio of 1.1 to 1.0 during any period that borrowing availability is less than \$10,000.

The Company can use the proceeds of the senior credit facility for general corporate purposes, including financing acquisitions and refinancing other indebtedness. As of June 30, 2012, the unused borrowing availability under the senior credit facility was \$19,320.

Table of Contents

9

---

## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

## Mortgage Note Payable

On September 13, 2011, the Company entered into a five-year \$11,063 mortgage loan. The mortgage loan is secured by the Company's Susan Street facility and liens secondary to the senior credit facility. The mortgage loan is scheduled to mature on September 13, 2016. The mortgage loan bears interest at a variable rate equal to one month LIBOR plus 3.00% and is payable in equal monthly installments of principal of \$61, plus interest calculated on the declining balance of the mortgage loan, with a final payment of \$7,436 due on maturity.

## NOTE I - FAIR VALUE MEASUREMENTS

Fair value is defined as the exchange value of an asset or a liability in an orderly transaction between market participants. The fair value guidance outlines a valuation framework and establishes a fair value hierarchy in order to increase the consistency and comparability of fair value measurements and disclosures. The hierarchy consists of three levels as follows:

Level 1 - Quoted market prices in active markets for identical assets or liabilities as of the reported date;

Level 2 - Other than quoted market prices in active markets for identical assets or liabilities, quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and other than quoted prices for assets or liabilities and prices that are derived principally from or corroborated by market data by correlation or other means; and

Level 3 - Measurements using management's best estimate of fair value, where the determination of fair value requires significant management judgment or estimation.

The Company's interest rate swaps and related instruments are measured under the fair value guidance. The following table summarizes the hierarchy level the Company used to determine fair value of its interest rate swaps and related instruments as of June 30, 2012 and December 31, 2011:

|                         | June 30,<br>2012 | December 31,<br>2011 | Fair Value<br>Hierarchy Level |
|-------------------------|------------------|----------------------|-------------------------------|
| Assets:                 |                  |                      |                               |
| Interest rate swaptions | \$279            | \$197                | Level 2                       |
| Liabilities:            |                  |                      |                               |
| Interest rate swaps     | \$1,159          | \$958                | Level 2                       |

The fair value of the interest rate swaps and swaptions was obtained from external sources. The interest rate swaps and swaptions were valued using observable inputs (e.g., LIBOR yield curves, credit spreads). Valuations of interest rate swaps may fluctuate considerably from period-to-period due to volatility in underlying interest rates, which are driven by market conditions and the duration of the instrument. Credit adjustments could have a significant impact on the

valuations due to changes in credit ratings of the Company or its counterparties.

The carrying amounts and estimated fair values of the Company's financial instruments are summarized as follows:

|                                                              | June 30, 2012      |               | December 31, 2011  |               |
|--------------------------------------------------------------|--------------------|---------------|--------------------|---------------|
|                                                              | Carrying<br>Amount | Fair<br>Value | Carrying<br>Amount | Fair<br>Value |
| Financial assets:                                            |                    |               |                    |               |
| Cash and cash equivalents                                    | \$240              | \$240         | \$298              | \$298         |
| Notes receivable, including current portion                  | 476                | 476           | 483                | 483           |
| Interest rate swaptions                                      | 279                | 279           | 197                | 197           |
| Financial Liabilities:                                       |                    |               |                    |               |
| Long-term debt and capital leases, including current portion | 75,565             | 78,164        | 68,086             | 68,900        |
| Interest rate swaps                                          | 1,159              | 1,159         | 958                | 958           |

Table of Contents

10

---

## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

The fair values of the Company's long-term debt and capital leases were estimated using market rates the Company believes would be available for similar types of financial instruments and represent level 2 measurements. The fair values of cash and cash equivalents and notes receivable approximate their carrying amounts due to the short-term nature of the financial instruments.

The Company's earnings, cash flows and financial position are exposed to market risks relating to interest rates. It is the Company's policy to minimize its exposure to adverse changes in interest rates and manage interest rate risks inherent in funding the Company with debt. The Company addresses this risk by maintaining a mix of fixed and floating rate debt and entering into interest rate swaps for a portion of its variable rate debt to minimize interest rate volatility. The Company does not hold speculative financial instruments, nor does it hold or issue financial instruments for trading purposes.

Derivatives designated as cash flow hedges relate to specific liabilities on the Company's Consolidated Condensed Balance Sheets. The Company assesses, both at inception and on an ongoing basis, whether the derivatives that are used in the hedging transactions are highly effective in offsetting changes in cash flows of the hedged items. When it is determined that a derivative is not highly effective or the derivative expires, is sold, terminated or exercised, the Company discontinues hedge accounting for that specific instrument. Changes in the fair value of effective cash flow hedges are deferred in accumulated other comprehensive income (loss) ("AOCIL") and reclassified into earnings in the same periods during which the hedged transaction affects earnings. Changes in the fair value of derivatives that are not effective hedges or that are not designated as hedges are recognized in income.

The following is a summary of the Company's interest rate swaps and swaptions as of June 30, 2012:

| Type               | Notional Amount | Effective Date                                                            | Fixed Rate | Variable Rate |
|--------------------|-----------------|---------------------------------------------------------------------------|------------|---------------|
| Interest rate swap | \$5,270         | * April 1, 2003 through April 1, 2013                                     | 4.54%      | 1 Month LIBOR |
| Interest rate swap | \$25,000        | July 11, 2010 through May 11, 2013                                        | 1.42%      | 1 Month LIBOR |
| Interest rate swap | \$10,000        | October 3, 2011 through September 1, 2016                                 | 1.33%      | 1 Month LIBOR |
| Interest rate swap | \$10,000        | March 1, 2013 through September 1, 2016                                   | 1.62%      | 1 Month LIBOR |
| Swaption           | \$10,000        | March 1, 2013 through September 1, 2016, exercisable on September 2, 2014 | 2.00%      | 1 Month LIBOR |
| Interest rate swap | \$5,000         | June 1, 2013 through September 1, 2016                                    | 1.70%      | 1 Month LIBOR |
| Swaption           | \$5,000         | June 1, 2013 through September 1, 2016, exercisable on September 1, 2015  | 1.88%      | 1 Month LIBOR |

\* Interest rate swap has an amortizing notional amount.

The following table summarizes the fair values of derivative instruments included in the Company's Consolidated Condensed Balance Sheets:

|                    | Location on Consolidated Condensed Balance Sheets | Fair Value<br>June 30,<br>2012 | December 31,<br>2011 |
|--------------------|---------------------------------------------------|--------------------------------|----------------------|
| Asset Derivatives: |                                                   |                                |                      |

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Derivatives not designated as hedging instruments:

|                         |              |       |       |
|-------------------------|--------------|-------|-------|
| Interest rate swaptions | Other Assets | \$279 | \$197 |
| Total Asset Derivatives |              | 279   | 197   |

Liability Derivatives:

Derivatives designated as hedging instruments:

|                                        |                             |       |       |
|----------------------------------------|-----------------------------|-------|-------|
| Interest rate swaps, current portion   | Accrued Expenses            | \$563 | \$559 |
| Interest rate swaps, long term portion | Other Long-Term Liabilities | 596   | 399   |
| Total Liability Derivatives            |                             | 1,159 | 958   |

Table of Contents

11

---

## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

The following tables summarize the pre-tax impact of derivative instruments on the Company's financial statements:

|                                                | Amount of Gain or (Loss) Recognized in AOCIL on the effective portion of the Derivative |          |                  |          |
|------------------------------------------------|-----------------------------------------------------------------------------------------|----------|------------------|----------|
|                                                | Three Months Ended                                                                      |          | Six Months Ended |          |
|                                                | June 30,                                                                                | July 2,  | June 30,         | July 2,  |
|                                                | 2012                                                                                    | 2011     | 2012             | 2011     |
| Derivatives designated as hedging instruments: |                                                                                         |          |                  |          |
| Cash flow hedges - interest rate swaps         | \$(388                                                                                  | ) \$(259 | ) \$(518         | ) \$(213 |

|                                                | Amount of Gain or (Loss) Reclassified from AOCIL on the effective portion into Income (1)(2) |          |                  |          |
|------------------------------------------------|----------------------------------------------------------------------------------------------|----------|------------------|----------|
|                                                | Three Months Ended                                                                           |          | Six Months Ended |          |
|                                                | June 30,                                                                                     | July 2,  | June 30,         | July 2,  |
|                                                | 2012                                                                                         | 2011     | 2012             | 2011     |
| Derivatives designated as hedging instruments: |                                                                                              |          |                  |          |
| Cash flow hedges - interest rate swaps         | \$(156                                                                                       | ) \$(137 | ) \$(312         | ) \$(277 |

|                                                | Amount of Gain or (Loss) Recognized on the ineffective portion in Income on Derivative (3) |         |                  |         |
|------------------------------------------------|--------------------------------------------------------------------------------------------|---------|------------------|---------|
|                                                | Three Months Ended                                                                         |         | Six Months Ended |         |
|                                                | June 30,                                                                                   | July 2, | June 30,         | July 2, |
|                                                | 2012                                                                                       | 2011    | 2012             | 2011    |
| Derivatives designated as hedging instruments: |                                                                                            |         |                  |         |
| Cash flow hedges - interest rate swaps         | \$—                                                                                        | \$(1    | ) \$—            | \$1     |

|                                                    | Amount of Gain or (Loss) Recognized in Income on Derivative (4) |         |                  |         |
|----------------------------------------------------|-----------------------------------------------------------------|---------|------------------|---------|
|                                                    | Three Months Ended                                              |         | Six Months Ended |         |
|                                                    | June 30,                                                        | July 2, | June 30,         | July 2, |
|                                                    | 2012                                                            | 2011    | 2012             | 2011    |
| Derivatives not designated as hedging instruments: |                                                                 |         |                  |         |
| Interest rate swaptions                            | \$96                                                            | \$—     | \$82             | \$—     |

(1) The amount of gain (loss) reclassified from AOCIL is included in interest expense on the Company's Consolidated Condensed Statements of Operations.

(2) The amount of loss expected to be reclassified from AOCIL into earnings during the next 12 months subsequent to June 30, 2012 is \$563.

- (3) The amount of gain (loss) recognized in income on the ineffective portion of interest rate swaps is included in other (income) expense, net on the Company's Consolidated Condensed Statements of Operations.
- (4) The amount of gain (loss) recognized in income for derivatives not designated as hedging instruments is included in other (income) expense, net on the Company's Consolidated Condensed Statements of Operations.

## NOTE J - EMPLOYEE BENEFIT PLANS

### Defined Contribution Plans

The Company sponsors a 401(k) defined contribution plan that covers a significant portion, or approximately 70% of the Company's associates. This plan was modified in 2012 compared with prior years to include a mandatory Company match on the first 1% of participants' contributions. The Company matches the next 2% of participants' contributions if the Company meets prescribed earnings levels. The plan also provides for additional Company contributions above the 3% level if the Company attains certain additional performance targets. The Company, at its discretion, did not match participants' contributions

### Table of Contents

12

---

## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

in 2011. Matching contribution expense for this 401(k) plan was \$0 for the three months ended June 30, 2012 and was \$131 for the six months ended June 30, 2012.

Additionally, the Company sponsors a smaller 401(K) defined contribution plan that covers those associates at one facility who are under a collective-bargaining agreement, or approximately 30% of the Company's associates. Under this plan, the Company generally matches participants' contributions, on a sliding scale, up to a maximum of 2.75% of the participant's earnings. Matching contribution expense for the collective-bargaining 401(k) plan was \$24 and \$25 for the three months ended June 30, 2012 and July 2, 2011, respectively, and \$45 and \$48 for the six months ended June 30, 2012 and July 2, 2011, respectively.

## Non-Qualified Retirement Savings Plan

The Company sponsors a non-qualified retirement savings plan that allows eligible associates to defer a specified percentage of their compensation. The obligations owed to participants under this plan were \$10,846 at June 30, 2012 and \$10,927 at December 31, 2011 and are included in other long-term liabilities in the Company's Consolidated Condensed Balance Sheets. The obligations are unsecured general obligations of the Company and the participants have no right, interest or claim in the assets of the Company, except as unsecured general creditors. The Company utilizes a Rabbi Trust to hold, invest and reinvest deferrals and contributions under the plan. Amounts are invested in company-owned life insurance in the Rabbi Trust and the cash surrender value of the policies was \$11,510 at June 30, 2012 and \$10,913 at December 31, 2011 and is included in other assets in the Company's Consolidated Condensed Balance Sheets.

## Multi-Employer Pension Plan

The Company contributes to a multi-employer pension plan under the terms of a collective-bargaining agreement that covers its union-represented employees. Expenses related to the multi-employer pension plan were \$63 and \$74 for the three months ended June 30, 2012 and July 2, 2011, respectively, and \$134 and \$146 for the six months ended June 30, 2012 and July 2, 2011, respectively.

## Postretirement Plans

The Company sponsors a legacy postretirement benefit plan that provides life insurance to a limited number of associates as a result of a prior acquisition. The Company also sponsors a postretirement benefit plan that provides medical insurance for a limited number of associates who retired prior to January 1, 2003 and life insurance to a limited number of associates upon retirement.

Components of net periodic benefit cost (credit) for all postretirement plans are summarized as follows:

|                                       | Three Months Ended |                 | Six Months Ended |                 |
|---------------------------------------|--------------------|-----------------|------------------|-----------------|
|                                       | June 30,<br>2012   | July 2,<br>2011 | June 30,<br>2012 | July 2,<br>2011 |
| Service cost                          | \$2                | \$2             | \$4              | \$4             |
| Interest cost                         | 6                  | 6               | 12               | 13              |
| Amortization of prior service credits | (22                | ) (22           | ) (44            | ) (45           |
| Recognized net actuarial gains        | (9                 | ) (7            | ) (19            | ) (15           |

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|                                    |       |         |         |         |   |
|------------------------------------|-------|---------|---------|---------|---|
| Net periodic benefit cost (credit) | \$(23 | ) \$(21 | ) \$(47 | ) \$(43 | ) |
|------------------------------------|-------|---------|---------|---------|---|

Amounts contributed or expected to be contributed by the Company during the current fiscal year to its postretirement plans are not anticipated to be significantly different from amounts disclosed in the Company's 2011 Annual Report filed on Form 10-K.

### NOTE K - INCOME TAXES

The Company's effective income tax provision (benefit) rate, based upon estimated annual income tax rates, was (42.9)% for the three months ended June 30, 2012, 41.9% for the three months ended July 2, 2011, (37.7)% for the six months ended June 30, 2012 and 32.2% for the six months ended July 2, 2011. The difference between the effective rate and the statutory rates for the three and six months ended June 30, 2012 and the three months ended July 2, 2011 was primarily due to the effect of the domestic manufacturing deduction, change in state valuation allowances, and a benefit recognized due to a adjustment of deferred taxes. The three and six months ended June 30, 2012 included interest charges related to an IRS audit for tax years 2004 through 2009. The difference for the six months ended July 2, 2011 was primarily due to the inclusion of a \$492 non-taxable settlement gain associated with a company-owned insurance policy.

### Table of Contents

13

---

## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

The Company and its subsidiaries are subject to United States federal income taxes, as well as income taxes in a number of state jurisdictions. The tax years subsequent to 2003 remain open to examination for U.S. federal income taxes. The majority of state jurisdictions remain open for tax years subsequent to 2007. A few state jurisdictions remain open to examination for tax years subsequent to 2006.

The Company's unrecognized tax benefits were \$16 at June 30, 2012 and December 31, 2011. Due to the Company's valuation allowances, such benefits, if recognized, would not significantly affect the Company's effective tax rate.

There were no significant interest or penalties accrued as of June 30, 2012 or December 31, 2011. The Company does not expect its unrecognized tax benefits to change significantly during the next twelve months. The Company recognizes interest and penalties related to uncertain tax positions, if any, in income tax expense.

## NOTE L - COMMON STOCK AND EARNINGS (LOSS) PER SHARE

The following table sets forth the computation of basic and diluted earnings (loss) per share from continuing operations:

|                                                                                   | Three Months Ended |                 | Six Months Ended |                 |
|-----------------------------------------------------------------------------------|--------------------|-----------------|------------------|-----------------|
|                                                                                   | June 30,<br>2012   | July 2,<br>2011 | June 30,<br>2012 | July 2,<br>2011 |
| Basic earnings (loss) per share:                                                  |                    |                 |                  |                 |
| Income (loss) from continuing operations                                          | \$(404             | ) \$808         | \$(508           | ) \$1,452       |
| Less: Allocation of earnings to participating securities                          | —                  | (19             | ) —              | (35             |
| Income (loss) from continuing operations available to common shareholders - basic | \$(404             | ) \$789         | \$(508           | ) \$1,417       |
| Basic weighted-average shares outstanding (1)                                     | 12,633             | 12,596          | 12,619           | 12,574          |
| Basic earnings (loss) per share - continuing operations                           | (0.03              | ) 0.06          | (0.04            | ) 0.11          |
| Diluted earnings (loss) per share:                                                |                    |                 |                  |                 |
| Income (loss) from continuing operations available to common shareholders - basic | \$(404             | ) \$789         | \$(508           | ) \$1,417       |
| Add: Undistributed earnings reallocated to unvested shareholders                  | —                  | 19              | —                | 35              |
| Income (loss) from continuing operations available to common shareholders - basic | \$(404             | ) \$808         | \$(508           | ) \$1,452       |
| Basic weighted-average shares outstanding (1)                                     | 12,633             | 12,596          | 12,619           | 12,574          |
| Effect of dilutive securities:                                                    |                    |                 |                  |                 |
| Stock options (2)                                                                 | —                  | 2               | —                | 2               |
| Directors' stock performance units (2)                                            | —                  | 50              | —                | 48              |
| Diluted weighted-average shares outstanding (1)(2)                                | 12,633             | 12,648          | 12,619           | 12,624          |
|                                                                                   | (0.03              | ) 0.06          | (0.04            | ) 0.11          |

Diluted earnings (loss) per share - continuing operations

(1) Includes Common and Class B Common shares, less shares held in treasury, in thousands.

Because their effects are anti-dilutive, shares issuable under stock option plans where the exercise price is greater than the average market price of the Company's Common Stock at the end of the relevant period, unvested restricted stock deemed to be participating securities, directors' stock performance units, and shares issuable on conversion of subordinated debentures into shares of Common Stock have been excluded. Aggregate shares excluded for the three and six months ending June 30, 2012 were 879 and 870, respectively and for the three and six months ending July 2, 2011 were 1,080 and 1,119, respectively.

Table of Contents

14

---

## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

## NOTE M - OTHER COMPREHENSIVE INCOME (LOSS)

Components of other comprehensive income (loss) are as follows:

|                                                                                            | Three Months Ended |                 | Six Months Ended |                 |
|--------------------------------------------------------------------------------------------|--------------------|-----------------|------------------|-----------------|
|                                                                                            | June 30,<br>2012   | July 2,<br>2011 | June 30,<br>2012 | July 2,<br>2011 |
| Other comprehensive income (loss):                                                         |                    |                 |                  |                 |
| Unrealized gain (loss) on interest rate swaps:                                             |                    |                 |                  |                 |
| Before income taxes                                                                        | \$(388)            | ) \$(259)       | ) \$(518)        | ) \$(213)       |
| Income taxes                                                                               | (147)              | ) (98)          | ) (197)          | ) (81)          |
| Net of taxes                                                                               | (241)              | ) (161)         | ) (321)          | ) (132)         |
| Reclassification of loss into earnings from interest rate swaps:                           |                    |                 |                  |                 |
| Before income taxes                                                                        | 39                 | 137             | 77               | 277             |
| Income taxes                                                                               | 15                 | 52              | 29               | 105             |
| Net of taxes                                                                               | 24                 | 85              | 48               | 172             |
| Amortization of unrealized loss on dedesignated interest rate swaps:                       |                    |                 |                  |                 |
| Before income taxes                                                                        | 117                | —               | 236              | —               |
| Income taxes                                                                               | 44                 | —               | 89               | —               |
| Net of taxes                                                                               | 73                 | —               | 147              | —               |
| Reclassification of net actuarial gain into earnings from postretirement benefit plans:    |                    |                 |                  |                 |
| Before income taxes                                                                        | (9)                | ) (7)           | ) (19)           | ) (15)          |
| Income taxes                                                                               | (3)                | ) (3)           | ) (7)            | ) (6)           |
| Net of taxes                                                                               | (6)                | ) (4)           | ) (12)           | ) (9)           |
| Reclassification of prior service credits into earnings from postretirement benefit plans: |                    |                 |                  |                 |
| Before income taxes                                                                        | (22)               | ) (22)          | ) (44)           | ) (45)          |
| Income taxes                                                                               | (8)                | ) (8)           | ) (16)           | ) (17)          |
| Net of taxes                                                                               | (14)               | ) (14)          | ) (28)           | ) (28)          |
| Other comprehensive income (loss)                                                          | \$(164)            | ) \$(94)        | ) \$(166)        | ) \$3           |

Components of accumulated other comprehensive income (loss), net of tax, are as follows:

|                                                                                                           | Interest Rate<br>Swaps | Post-Retirement<br>Liabilities | Total  |
|-----------------------------------------------------------------------------------------------------------|------------------------|--------------------------------|--------|
| Balance at December 31, 2011                                                                              | \$(565)                | ) \$ 477                       | \$(88) |
| Unrealized gain (loss) on interest rate swaps, net of tax of \$197                                        | (321)                  | ) —                            | (321)  |
| Reclassification of loss into earnings from interest rate swaps, net of tax of \$29                       | 48                     | —                              | 48     |
| Amortization of unrealized loss on dedesignated interest rate swaps, net of tax of \$89                   | 147                    | —                              | 147    |
| Reclassification of net actuarial gain into earnings from postretirement benefit plans, net of tax of \$7 | —                      | (12)                           | ) (12) |

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|                                                                                                                  |        |     |        |        |   |
|------------------------------------------------------------------------------------------------------------------|--------|-----|--------|--------|---|
| Reclassification of prior service credits into earnings from<br>postretirement benefit plans, net of tax of \$16 | —      | (28 | )      | (28    | ) |
| Balance at June 30, 2012                                                                                         | \$(691 | )   | \$ 437 | \$(254 | ) |

Table of Contents

15

---

## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

## NOTE N - OTHER (INCOME) EXPENSE

Other operating (income) expense, net is summarized as follows:

|                                                 | Three Months Ended |                 | Six Months Ended |                 |
|-------------------------------------------------|--------------------|-----------------|------------------|-----------------|
|                                                 | June 30,<br>2012   | July 2,<br>2011 | June 30,<br>2012 | July 2,<br>2011 |
| Other operating (income) expense, net:          |                    |                 |                  |                 |
| Insurance proceeds (1)                          | \$—                | \$—             | \$—              | \$(492 )        |
| Gain on property, plant and equipment disposals | —                  | (1 )            | —                | (2 )            |
| Retirement expenses                             | 53                 | 85              | 136              | 156             |
| Miscellaneous (income) expense                  | 23                 | (42 )           | (40 )            | (112 )          |
| Other operating (income) expense, net           | \$76               | \$42            | \$96             | \$(450 )        |

(1) The Company recognized a settlement gain of \$492 from a company-owned insurance policy during the six months ending July 2, 2011.

Other (income) expense, net is summarized as follows:

|                                | Three Months Ended |                 | Six Months Ended |                 |
|--------------------------------|--------------------|-----------------|------------------|-----------------|
|                                | June 30,<br>2012   | July 2,<br>2011 | June 30,<br>2012 | July 2,<br>2011 |
| Other (income) expense, net:   |                    |                 |                  |                 |
| Gain on non-hedged swaptions   | \$(96 )            | \$—             | \$(82 )          | \$—             |
| Miscellaneous (income) expense | 1                  | 10              | (10 )            | (6 )            |
| Other (income) expense, net    | \$(95 )            | \$10            | \$(92 )          | \$(6 )          |

## NOTE O - FACILITY CONSOLIDATION AND SEVERANCE EXPENSES, NET

## 2008 Facilities Consolidation

In 2008 and 2009, in response to the difficult economic conditions, the Company consolidated certain manufacturing operations and ceased operating in a leased facility and made organizational changes to reduce staff and expenses throughout the Company ("2008 Facilities Consolidation"). Costs related to the facilities consolidation included equipment and inventory relocation, severance costs, employee relocation, asset impairments and costs associated with terminating a lease obligation. During the six months ended July 2, 2011, the Company terminated the lease obligation and paid a termination fee of \$700 resulting in a gain of \$551 from the reduction of previously accrued estimates associated with this plan. Total costs to complete this restructuring plan were \$7,410. There are no remaining costs to be incurred under this plan.

## 2009 Organization Restructuring

In 2009, the Company developed and implemented a plan to realign its organizational structure to combine its three residential carpet units into one business with three distinct brands ("2009 Organization Restructuring"). As a result,

the Company's residential business is organized much like its commercial carpet business and more like the rest of the industry. Costs related to the organization realignment included severance costs, associate relocation expenses and costs related to the migration of certain computer applications necessary to support the realignment. During the six months ended July 2, 2011, the Company had a reduction of expenses of \$12 associated with this plan. Total costs to complete this restructuring plan were \$1,450. There are no remaining costs to be incurred under this plan.

#### NOTE P - CONTINGENCIES

The Company assesses its exposure related to legal matters, including those pertaining to product liability, safety and health matters and other items that arise in the regular course of its business. If the Company determines that it is probable a loss has been incurred, the amount of the loss, or an amount within the range of loss, that can be reasonably estimated will be recorded.

#### Table of Contents

16

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## THE DIXIE GROUP, INC.

## NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(UNAUDITED)

(dollars in thousands, except per share data) (Cont'd.)

## Environmental Remediation

The Company accrues for losses associated with environmental remediation obligations when such losses are probable and estimable. Remediation obligations are accrued based on the latest available information and are recorded at undiscounted amounts. The Company regularly monitors the progress of environmental remediation. Should studies indicate that the cost of remediation has changed from the previous estimate, an adjustment to the liability would be recorded in the period in which such determination is made. (See Note Q)

## NOTE Q - DISCONTINUED OPERATIONS

The Company has previously either sold or discontinued certain operations that are accounted for as "Discontinued Operations" under the applicable accounting guidance. The Company has certain contingent obligations directly related to such operations, primarily related to self-insured workers' compensation and environmental liabilities. Costs related to these obligations for those businesses are classified as discontinued operations. Discontinued operations are summarized as follows:

|                                                 | Three Months Ended |                 | Six Months Ended |                 |
|-------------------------------------------------|--------------------|-----------------|------------------|-----------------|
|                                                 | June 30,<br>2012   | July 2,<br>2011 | June 30,<br>2012 | July 2,<br>2011 |
| Loss from discontinued operations:              |                    |                 |                  |                 |
| Workers' compensation costs                     | \$(16              | ) \$—           | \$(33            | ) \$(23         |
| Environmental remediation costs                 | (35                | ) (67           | ) (125           | ) (76           |
| Loss from discontinued operations, before taxes | (51                | ) (67           | ) (158           | ) (99           |
| Income tax benefit                              | (22                | ) (25           | ) (52            | ) (37           |
| Loss from discontinued operations, net of tax   | \$(29              | ) \$(42         | ) \$(106         | ) \$(62         |

## Workers' Compensation

Undiscounted reserves are maintained for the self-insured workers' compensation obligations. These reserves are administered by a third party workers' compensation service provider under the supervision of Company personnel. Such reserves are reassessed on a quarterly basis. Pre-tax cost incurred for workers' compensation as a component of discontinued operations primarily represents a change in estimate for each period from unanticipated medical costs associated with the Company's obligations.

## Environmental Remediation

Reserves for environmental remediation obligations are established on an undiscounted basis. The Company has ongoing obligations at five previously owned sites that were associated with its discontinued textile businesses. Each of these sites contains relatively low levels of ground or ground water contaminants. Each site has a Corrective Action Plan ("CAP") with the applicable authoritative state regulatory body responsible for oversight for environmental compliance and the Company contracts with third party qualified environmental specialists for related remediation, monitoring and reporting for each location. The CAP for four of these sites involves natural attenuation (degradation of the contaminants through naturally occurring events) over periods currently estimated at 10 to 20 years and the

CAP on the remaining site involves a pump and treat remediation process, currently estimated to remediate over a period of 25 years. Additionally, the Company has an environmental liability related to the property of a facility and related business that was sold in 2004. The CAP, involving an oxidation-based remediation plan, was approved in 2010 and is currently estimated to remediate over a 7 year period beginning in 2010. The Company has an accrual for environmental remediation obligations of \$1,756 and \$1,733 as of June 30, 2012 and December 31, 2011, respectively. The actual timeline to remediate, and thus, the ultimate cost to complete such remediation through these remediation efforts, may differ significantly from our estimates. Pre-tax cost for environmental remediation obligations classified as discontinued operations were primarily a result of specific events requiring action and additional expense in each period.

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

The following is presented to update the discussion of results of operations and financial condition included in our 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

### CRITICAL ACCOUNTING POLICIES

Our critical accounting policies were outlined in Management's Discussion and Analysis of Results of Operations and Financial Condition in our 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission. There have been no changes to those critical accounting policies subsequent to the date of that report.

### OVERVIEW

At year end, we noted that since the historic downturn that began in 2008-2009, our sales had grown substantially ahead of the industry. Although our residential sales growth has continued to exceed that of the industry, our commercial business has significantly underperformed the industry during the first six months of 2012. However, our backlog for commercial products increased significantly from the end of our first quarter of 2012. Our residential sales growth rate was sustained by growth in our upper-end retail brands that more than offset a decline in sales to the mass merchant sector. Sales in our commercial sector substantially underperformed the comparable year ago sales period, which was very strong, and we have seen a significant softening of commercial business since the middle of 2011. We are taking advantage of several opportunities to invest in products we believe will further differentiate us from the competition. We have access to two new yarn systems that are limited in distribution and provide exceptional softness and colorfastness qualities. In addition, we have developed a new "permaset process" for wool which will allow our designer customers unlimited choice of colorations. As a result, during 2012 we have invested at an increased rate in sampling initiatives related to these product offerings as compared to the same periods in the prior year.

Beginning in the latter part of our first quarter of 2012 and continuing through the second quarter, we have relocated certain of our tufting technologies from our manufacturing facility in Atmore, Alabama to our facility in Eton, Georgia to achieve a more favorable cost structure for the products and markets served from those technologies. We expect to have the tufting realignment complete during our third quarter. In addition, during the second quarter, we relocated certain carpet shearing equipment from our Eton facility to our Atmore facility to accommodate quality requirements. These actions resulted in incremental operating costs during the second quarter and first six months of 2012.

We remain cautiously optimistic about conditions that affect the higher-end residential markets we serve and continue to address initiatives in our commercial offerings related to our products, manufacturing processes and distribution alternatives. Additionally, in an effort to strengthen our performance in our commercial sector, we will be bringing in new leadership for our commercial business. Although, raw material prices we believe have peaked, we experienced increases in certain of our raw material costs in the first half of 2012. We implemented sales price increases to recoup these cost increases, as has the industry.

### RESULTS OF OPERATIONS

Our second quarters of 2012 and 2011 each contained 13 operating weeks. Our first quarter of 2012 contained 13 operating weeks compared with 14 operating weeks in the first quarter of 2011; therefore, the first six months of 2012 contained 26 operating weeks compared with 27 operating weeks in the first six months of 2011. Discussions below related to percentage changes in net sales during the six month periods have been adjusted to reflect the comparable number of weeks in the reporting periods and are qualified with the term "net sales as adjusted". We believe "net sales as adjusted" will assist our financial statement users to better understand the rate of growth in our business in the comparative periods. (See reconciliation of net sales to net sales as adjusted below.)

Reconciliation of Net Sales to Net Sales as Adjusted

|                          | Six Months Ended |                 | Percent<br>Increase/(Decrease) |
|--------------------------|------------------|-----------------|--------------------------------|
|                          | June 30,<br>2012 | July 2,<br>2011 |                                |
| Net sales as reported    | \$ 129,416       | \$ 135,154      | (4.2 ) %                       |
| Adjustment to net sales: |                  |                 |                                |
| Impact of shipping weeks | —                | (4,711 )        |                                |
| Net sales as adjusted    | \$ 129,416       | \$ 130,443      | (0.8 ) %                       |

Table of Contents

18

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The following table sets forth certain elements of our continuing operating results as a percentage of net sales for the periods indicated:

|                                                    | Three Months Ended |    |                 |    | Six Months Ended |   |              |    |
|----------------------------------------------------|--------------------|----|-----------------|----|------------------|---|--------------|----|
|                                                    | June 30,<br>2012   |    | July 2,<br>2011 |    | June 30,<br>2012 |   | July 2, 2011 |    |
| Net sales                                          | 100.0              | %  | 100.0           | %  | 100.0            | % | 100.0        | %  |
| Cost of sales                                      | 76.4               | %  | 75.8            | %  | 75.7             | % | 75.4         | %  |
| Gross profit                                       | 23.6               | %  | 24.2            | %  | 24.3             | % | 24.6         | %  |
| Selling and administrative expense                 | 23.6               | %  | 21.6            | %  | 23.8             | % | 22.4         | %  |
| Other operating (income)/expense                   | 0.1                | %  | 0.1             | %  | 0.1              | % | (0.3)        | )% |
| Facility consolidation and severance expenses, net | —                  | %  | (0.8)           | )% | —                | % | (0.4)        | )% |
| Operating income (loss)                            | (0.1)              | )% | 3.3             | %  | 0.4              | % | 2.9          | %  |

**Net Sales.** Net sales for the quarter ended June 30, 2012 were \$66.6 million compared with net sales of \$69.2 million for the year-earlier quarter, or a decline 3.8%. Net sales in the first six months of 2012 were \$129.4 million compared with net sales of \$135.2 million in the first six months of 2011, a decline of 4.2%, or 0.8%, on a “net sales as adjusted” basis. In the second quarter of 2012, residential carpet sales reflected an increase of 5.6% and net sales of commercial carpet decreased 25.3% compared with the second quarter of 2011. Residential carpet sales increased 1.9%, or 5.6% on net sales as adjusted, and commercial net sales decreased 20.1%, or 17.3% on net sales as adjusted in the first six months of 2012 compared with the first six months of 2011. Our residential sales in the second quarter and first six months of 2012, compared with the prior-year periods, included increased sales through our higher-end retail and designer channels while residential sales declined through our mass merchant channels of distribution which are less predictable and more prone to volatility as a result of merchandising specials prevalent in the mass merchant channels. Our commercial business is more heavily concentrated in specified project oriented business which, we believe, is significantly affected by general economic uncertainties. Additionally, our commercial sales comparisons in both the second quarter and first six months of 2012 are negatively affected by extremely strong sales in the 2011 periods when we were significantly outperforming the industry in sales growth.

**Cost of Sales.** Cost of sales as a percentage of net sales was 76.4% in the second quarter of 2012 compared with 75.8% in the second quarter of 2011. Cost of sales was 75.7% in the first six months of 2012 compared with 75.4% in the first six months of 2011. The increase in cost of sales as a percentage of sales in both the second quarter and first six months was partially attributable to the effects of costs incurred in the 2012 periods related to the machinery realignments discussed in the overview section above as well as higher expenses due to the development of new fibers.

**Gross Profit.** Gross profit dollars decreased \$1.0 million in the second quarter of 2012 compared with the second quarter 2011 and decreased \$1.9 million in the first six months of 2012 compared with the same period in 2011 primarily reflecting the effects of the decreased sales volume and higher costs of sales. In the second quarter and first six months of 2012, gross profit as a percentage of sales declined 0.6% and 0.3%, respectively compared with the 2011 periods. The second quarter and first six months of 2012 included incremental costs of \$536 thousand and \$754 thousand, respectively, associated with the equipment realignment discussed above.

**Selling and Administrative Expenses.** Selling and administrative expenses increased 2.0% as a percentage of sales in the second quarter of 2012 compared with the same period in 2011 and increased 1.4% as a percent of sales in the first six months of 2012 compared with the first six months of 2011. The higher selling and administrative expenses as a percentage of sales is primarily a result of the increased sampling costs in the 2012 periods related to the new product initiatives discussed in the overview section above.

Other Operating (Income) Expense, Net. Other operating expense was negligible in the second quarters of 2012 and 2011 and for the first six months of 2012. The first six months of 2011 included a gain of \$492 thousand related to the settlement of a company-owned insurance policy.

Facility Consolidation and Severance Expenses, Net. We fulfilled our lease agreement obligations associated with our California facility in the second quarter of 2011 resulting in the recognition of a \$563 thousand gain as a result of the reversal of previously estimated contractual obligations under the lease agreement.

Operating Income (Loss). We reported an operating loss of \$40 thousand in the second quarter of 2012 compared with operating income of \$2.3 million in the second quarter of 2011. Operating income was \$580 thousand in the first six months of 2012 compared with operating income of \$4.0 million in the first six months of 2011. Operating results in the 2012 reporting periods were negatively affected by the lower sales volume, incremental equipment relocation expenses and increased sample costs. Operating results in 2011 were favorably affected by the gains from the facilities consolidation and settlement of the company-owned insurance policy.

Table of Contents

19

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**Interest Expense.** Interest expense decreased \$138 thousand in the second quarter of 2012 and \$344 thousand for the first six months of 2012, respectively compared with the same periods in 2011. The reductions are principally a result of lower interest rates in the 2012 periods compared with the 2011 periods, including the effects of related interest rate swaps.

**Other Income Expense, Net.** Other income in the second quarter and first six months of 2012 included a gain of \$96 thousand from a non-hedged financial debt instrument.

**Income Tax Provision (Benefit).** Our effective income tax benefit rate was 42.9% in the second quarter of 2012 and 37.7% for the first six months of 2012 compared with a tax provision rate of 41.9% in the second quarter of 2011 and 32.2% for the first six months of 2011. The effective tax rates in the second quarter of 2012 and 2011 and the first six months of 2012 differed from statutory rates primarily as a result of the estimated effects of certain manufacturing related tax deductions, changes in state valuation allowances, and the adjustment of deferred taxes. The 2012 periods additionally included interest related to the settlement of an IRS audit. The tax rate for the first six months of 2011 differed from statutory rates principally as a result of a non-taxable settlement gain in the first quarter of 2011 related to company-owned insurance and the effects of permanent differences on pre-tax earnings utilized in the tax calculations in the 2011 reporting period.

**Income (Loss) from Continuing Operations.** We had a loss from continuing operations of \$404 thousand, or \$0.03 per diluted share in the second quarter of 2012 compared with income from continuing operations of \$808 thousand, or \$0.06 per diluted share in the second quarter of 2011. Continuing operations reflected a loss of \$508 thousand, or \$0.04 per diluted share, for the first six months of 2012 compared with income from continuing operations of \$1.5 million, or \$0.11 per diluted share, in the first six months of 2011.

**Net Income (Loss).** Discontinued operations reflected a loss of \$29 thousand, or \$0.00 per diluted share, in the second quarter of 2012 compared with a loss of \$42 thousand, or \$0.00 per diluted share, in the same period in 2011. Discontinued operations reflected a loss of \$106 thousand, or \$0.01 per diluted share, in first the first six months of 2012 compared with a loss of \$62 thousand, or \$0.00 per diluted share, in the first six months of 2011. Including discontinued operations, we had a net loss of \$433 thousand, or \$0.03 per diluted share, in the second quarter of 2012 compared with net income of \$766 thousand, or \$0.06 per diluted share, in the second quarter of 2011. The first six months of 2012 reflected a loss of \$614 thousand, or \$0.05 per diluted share compared with net income of \$1.4 million, or \$0.11 per diluted share, in the comparable six month period in 2011.

## LIQUIDITY AND CAPITAL RESOURCES

During the six months ended June 30, 2012, debt increased \$6.9 million under our senior credit line and machinery note agreements and an additional \$575 thousand related to equipment acquired under a capitalized lease for a total increase in debt of \$7.5 million. The debt increase of \$6.9 million was used to finance our operations including \$5.6 million in operating activities, \$1.1 million in property, plant and equipment purchases, \$154 thousand to acquire our common stock for treasury, and a reduction in outstanding checks in excess of cash of \$93 thousand.

Working capital increased \$9.7 million in the first six months of 2012, principally as a result of an increase of \$9.0 million in inventories to accommodate anticipated increased seasonal levels of business. Receivables increased \$1.7 million while other current assets increased \$345 thousand. Accounts payable increased \$1.9 million primarily related to the higher levels of inventories while accrued expenses and the current portion of debt decreased \$1.2 million.

During the quarter ended June 30, 2012, we renegotiated an equipment operating lease resulting in the return of a security deposit of \$809 thousand from the lessor and the cancellation of a standby letter of credit of \$768 thousand by

the lessor that resulted in an increase in borrowing availability under our senior credit agreement.

Capital asset acquisitions for the six months ended June 30, 2012 were \$1.7 million; \$1.1 million through funded debt and \$631 thousand of equipment acquired under a capitalized lease, while depreciation and amortization was \$4.8 million. We expect capital expenditures to be approximately \$4.3 million for fiscal 2012, while depreciation and amortization is expected to be approximately \$9.6 million. Planned capital expenditures in 2012 are primarily for new equipment in both infrastructure support and production enhancements.

#### Debt Facilities

On September 14, 2011, we entered into a five-year, secured revolving credit facility (the "senior credit facility"). The senior credit facility provides for a maximum of \$90.0 million of revolving credit, subject to borrowing base availability, including limited amounts of credit in the form of letters of credit and swingline loans. The borrowing base is equal to specified percentages of our eligible accounts receivable, inventories and fixed assets less reserves established, from time to time, by the administrative agent under the senior credit facility.

At our election, revolving loans under the senior credit facility bear interest at annual rates equal to either (a) LIBOR for 1, 2 or 3 month periods, as we may select, plus an applicable margin of either 2.00% or 2.25%, or (b) the higher of the prime rate, the Federal Funds rate plus 0.5%, or a daily LIBOR rate, plus an applicable margin of either 1.00% or 1.50%. The applicable margin

#### Table of Contents

20

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is determined based on availability under the senior credit facility with margins increasing as availability decreases. We also pay an unused line fee on the average amount by which the aggregate commitments exceed utilization of the senior credit facility equal to 0.375% per annum.

The senior credit facility includes certain affirmative and negative covenants that impose restrictions on our financial and business operations, including limitations on debt, liens, investments, fundamental changes in our business, asset dispositions, dividends and other similar restricted payments, transactions with affiliates, payments and modifications of certain existing debt, future negative pledges, and changes in the nature of our business. We are also required to maintain a fixed charge coverage ratio of 1.1 to 1.0 during any period that borrowing availability is less than \$10.0 million.

We can use the proceeds of the senior credit facility for general corporate purposes, including financing acquisitions and refinancing other indebtedness. As of June 30, 2012, the unused borrowing availability under the senior credit facility was \$19.3 million.

On September 13, 2011, the Company entered into a five-year \$11.1 million mortgage loan. The mortgage loan is secured by the Company's Susan Street facility and liens secondary to the senior credit facility. The mortgage loan is scheduled to mature on September 13, 2016. The mortgage loan bears interest at a variable rate equal to one month LIBOR plus 3.00% and is payable in equal monthly installments of principal of \$61 thousand, plus interest calculated on the declining balance of the mortgage loan, with a final payment of \$7.4 million due on maturity.

#### RECENT ACCOUNTING PRONOUNCEMENTS

In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. This ASU represents the converged guidance of the FASB and the International Accounting Standards Board ("the Boards") on fair value measurement. The collective efforts of the Boards and their staffs have resulted in common requirements, including a consistent meaning of the term "fair value." The Boards have concluded the common requirements will result in greater comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and IFRS. The ASU was effective during the first quarter of 2012 and its adoption did not have a material effect on our Consolidated Condensed Financial Statements.

In June 2011, the FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. This ASU eliminates the option to report other comprehensive income and its components in the statement of stockholders equity and requires the presentation of comprehensive income in either (1) a continuous statement of comprehensive income or (2) two separate but consecutive statements. This ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. We early adopted this ASU in the prior year and presented the components of other comprehensive income in a separate statement following the statement of operations. In December 2011, the FASB issued ASU 2011-12, Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. ASU 2011-12 deferred the changes in ASU 2011-05 that relate to the presentation of reclassification adjustments to other comprehensive income. These amendments were delayed to allow the FASB time to redeliberate whether to present the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income on the face of the financial statements for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, we are required to continue reporting reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before ASU 2011-05.

In December 2011, the FASB issued ASU No. 2011-11, "Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities." The amendments in this ASU require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by

those amendments retrospectively for all comparative periods presented. We do not expect that the adoption of this ASU will have a material effect on our Consolidated Condensed Financial Statements.

#### CERTAIN FACTORS AFFECTING THE COMPANY'S PERFORMANCE

In addition to the other information provided in this Report, the risk factors included in Item 1A should be considered when evaluating the results of our operations, future prospects and an investment in shares of our Common Stock. Any of these factors could cause our actual financial results to differ materially from our historical results, and could give rise to events that might have a material adverse effect on our business, financial condition and results of operations.

#### Table of Contents

21

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## FORWARD-LOOKING INFORMATION

This Report contains statements that may be considered forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended. These statements include the use of terms or phrases that include such terms as "expects," "estimates," "projects," "believes," "anticipates," "intends," and similar terms and phrases. Such forward looking statements relate to, among other matters, our future financial performance, business prospects, growth strategies or liquidity. The following important factors may affect our future results and could cause those results to differ materially from our historical results; these factors include, in addition to those "Risk Factors" detailed in item 1A of this report and described elsewhere in this document, the cost and availability of capital, raw material and transportation costs related to petroleum price levels, the cost and availability of energy supplies, the loss of a significant customer or group of customers, materially adverse changes in economic conditions generally in carpet, rug and floor covering markets we serve and other risks detailed from time to time in our filings with the Securities and Exchange Commission

### Item 3. Quantitative and Qualitative Disclosures about Market Risk (Dollars in thousands)

Our earnings, cash flows and financial position are exposed to market risks relating to interest rates, among other factors. It is our policy to minimize our exposure to adverse changes in interest rates and manage interest rate risks inherent in funding our Company with debt. We address this financial exposure through a risk management program that includes maintaining a mix of fixed and floating rate debt and the use of interest rate swap agreements (See Note I to the Consolidated Condensed Financial Statements).

At June 30, 2012, \$30,972, or approximately 41% of our total debt, was subject to floating interest rates. A 10% fluctuation in the variable interest rates applicable to this floating rate debt would have an annual after-tax impact of approximately \$48.

### Item 4 - Controls and Procedures

We maintain disclosure controls and procedures to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms and is accumulated and communicated to management, including our principal executive officer and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Our management, under the supervision and with the participation of our Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as such terms are defined in Rules 13(a)-15(e) and 15(d)-15(e)) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") as of June 30, 2012, the date of the financial statements included in this Form 10-Q (the "Evaluation Date"). Based on that evaluation, our CEO and CFO concluded that our disclosure controls and procedures were effective as of the Evaluation Date.

No changes in our internal control over financial reporting occurred during the quarter covered by this report that materially affected, or are reasonably likely to affect, our internal control over financial reporting.

Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures, as well as diverse interpretation of U. S. generally accepted accounting principles by accounting professionals. It is also possible that internal control over financial reporting can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. Furthermore, projections of any evaluation of effectiveness to future periods

are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. These inherent limitations are known features of the financial reporting process; therefore, while it is possible to design into the process safeguards to reduce such risk, it is not possible to eliminate all risk.

Table of Contents

22

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## PART II. OTHER INFORMATION

### Item 1 - Legal Proceedings

None.

### Item 1A - Risk Factors

In addition to the other information provided in this Report, the following risk factors should be considered when evaluating the results of our operations, future prospects and an investment in shares of our Common Stock. Any of these factors could cause our actual financial results to differ materially from our historical results, and could give rise to events that might have a material adverse effect on our business, financial condition and results of operations.

The floorcovering industry is cyclical and prolonged declines in residential or commercial construction activity or corporate remodeling and refurbishment could have a material adverse effect on our business. Factors that affect such declines may include:

- consumer confidence;
- housing demand;
- financing availability;
- national and local economic conditions;
- interest rates;
- employment levels;
- changes in disposable income;
- commercial rental vacancy rates; and
- federal and state income tax policies.

Our product concentration in the higher-end of the residential and commercial markets could significantly affect the impact of these factors on our business.

We have significant levels of sales in certain channels of distribution.

A significant amount of our sales are generated through certain retail and mass merchant channels of distribution. A significant reduction of sales through these channels could adversely affect our results.

We have significant levels of indebtedness.

We have significant amounts of debt relative to our equity. If our cash flow or profitability are insufficient, the value of our assets securing our loans are insufficient or we are unable to access the debt or equity markets at competitive rates or in sufficient amounts, it could materially adversely affect our ability to generate sufficient funds to satisfy the terms of our senior loan agreements and other debt obligations.

We face intense competition in our industry, which could decrease demand for our products and could have a material adverse effect on our profitability.

The floorcovering industry is highly competitive. We face competition from a number of domestic manufacturers and independent distributors of floorcovering products and, in certain product areas, foreign manufacturers. There has been significant consolidation within the floorcovering industry that has caused a number of our existing and potential competitors to be significantly larger and have significantly greater resources and access to capital than we do. Maintaining our competitive position may require us to make substantial additional investments in our product

development efforts, manufacturing facilities, distribution network and sales and marketing activities, which may be limited by our access to capital, as well as restrictions set forth in our credit facilities. Competitive pressures may also result in decreased demand for our products and in the loss of market share. In addition, we face, and will continue to face, pressure on sales prices of our products from competitors. As a result of any of these factors, there could be a material adverse effect on our sales and profitability.

Raw material prices may increase.

The cost of raw materials has a significant impact on our profitability. In particular, our business requires the purchase of large volumes of nylon and polyester yarn, as well as wool yarns, synthetic backing, latex, and dyes.

Increases in the cost of these raw materials could materially adversely affect our business, results of operations and financial condition if we are unable to pass these increases through to our customers. We believe we are successful in passing along raw material and other cost increases as they may occur; however, there can be no assurance that we will successfully recover such increases in cost.

Unanticipated termination or interruption of our arrangements with third-party suppliers of nylon yarn could have a material adverse effect on us.

Nylon yarn is the principal raw material used in our floorcovering products. A significant portion of such yarn is purchased from one supplier. We believe there are other sources of nylon yarns; however, an unanticipated termination or interruption of our supply arrangements could adversely affect our ability to supply our customers and could be material.

Environmental, safety and health regulatory governance.

Various federal, state and local environmental laws govern the use of our current and former facilities. These laws govern such matters as:

- Discharges to air and water;
- Handling and disposal of solid and hazardous substances and waste; and
- Remediation of contamination from releases of hazardous substances in our facilities and off-site disposal locations.

Our operations also are governed by laws relating to workplace safety and worker health, which, among other things, establish noise standards and regulate the use of hazardous materials and chemicals in the workplace. We have taken, and will continue to take, steps to comply with these laws. If we fail to comply with present or future environmental or safety regulations, we could be subject to future liabilities. However, we cannot ensure that complying with these environmental or health and safety laws and requirements will not adversely affect our business, results of operations and financial condition. Future laws, ordinances or regulations could give rise to additional compliance or remediation costs that could have a material adverse effect on our business, results of operations and financial condition.

Acts of Terrorism.

Our business could be materially adversely affected as a result of international conflicts or acts of terrorism. Terrorist acts or acts of war may cause damage or disruption to our facilities, employees, customers, suppliers, and distributors, which could have a material adverse effect on our business, results of operations or financial condition. Such conflicts also may cause damage or disruption to transportation and communication systems and to our ability to manage logistics in such an environment, including receipt of supplies and distribution of products.

Unanticipated Business Interruptions.

Our business could be adversely affected if a significant portion of our plant, equipment or operations were damaged or interrupted by a casualty, condemnation, utility service, work stoppage or other event beyond our control. Such an event could have a material adverse effect on our business, results of operations and financial condition.

## Item 2 - Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information regarding our repurchases of shares of our Common Stock during the three months ended June 30, 2012:

| Month Ending | Total Number<br>of Shares<br>Purchased | Average Price<br>Paid Per Share | Total Number<br>of Shares<br>Purchased as<br>Part of Publicly<br>Announced<br>Plans or | Maximum<br>Number (or<br>approximate<br>dollar value) of<br>Shares That<br>May Yet Be |
|--------------|----------------------------------------|---------------------------------|----------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------|
|--------------|----------------------------------------|---------------------------------|----------------------------------------------------------------------------------------|---------------------------------------------------------------------------------------|

|                                  |   |     | Programs (1) | Purchased<br>Under Plans or<br>Programs |
|----------------------------------|---|-----|--------------|-----------------------------------------|
| May 5, 2012                      | — | \$— | —            |                                         |
| June 2, 2012                     | — | —   | —            |                                         |
| June 30, 2012                    | — | —   | —            |                                         |
| Three Months Ended June 30, 2012 | — | \$— | \$—          | \$4,520,679                             |

(1) On August 8, 2007, we announced a program to repurchase up to \$10 million of our Common Stock.

Table of Contents

24

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Item 3 - Defaults Upon Senior Securities

None.

Item 4 - Mine Safety Disclosures

Not Applicable.

Item 5 - Other Information

None.

Item 6 - Exhibits

(a.) Exhibits

31.1 CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 CEO Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 CFO Certification pursuant to 18 U.S. C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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.

THE DIXIE GROUP, INC.  
(Registrant)

Date: August 8, 2012

By: /s/ JON A. FAULKNER  
Jon A. Faulkner  
Vice President and Chief Financial Officer

Date: August 8, 2012

By: /s/ D. EUGENE LASATER  
D. Eugene Lasater  
Controller

Table of Contents

26