PFSWEB INC
Form 10-Q
November 14, 2011

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended September 30, 2011

OR

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

For the Transition Period from __________ to __________

Commission File Number 000-28275

PFSweb, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**75-2837058**
(State of Incorporation)	(I.R.S. Employer I.D. No.)
500 North Central Expressway, Plano, Texas	**75074**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(972) 881-2900**

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 þ No o

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

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

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

At November 10, 2011 there were 12,764,351 shares of registrant s common stock outstanding.

PFSWEB, INC. AND SUBSIDIARIES
Form 10-Q
September 30, 2011
INDEX

	Page Number
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements:	
Unaudited Consolidated Balance Sheets as of September 30, 2011 and December 31, 2010	3
Unaudited Interim Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2011 and 2010	4
Unaudited Interim Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2011 and 2010	5
Notes to Unaudited Interim Consolidated Financial Statements	6
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	16
Item 3. Quantitative and Qualitative Disclosure about Market Risk	26
Item 4. Controls and Procedures	26
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	27
Item 1A. Risk Factors	27
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	28
Item 3. Defaults Upon Senior Securities	28
Item 4. Removed and Reserved	28
Item 5. Other Information	28
Item 6. Exhibits and Reports on Form 8-K	28
SIGNATURE	30
EX-10.1	
EX-31.1	
EX-31.2	
EX-32.1	
EX-101 INSTANCE DOCUMENT	
EX-101 SCHEMA DOCUMENT	

EX-101 CALCULATION LINKBASE DOCUMENT
EX-101 LABELS LINKBASE DOCUMENT
EX-101 PRESENTATION LINKBASE DOCUMENT

Table of Contents

PART I. FINANCIAL INFORMATION
ITEM 1.
Financial
Statements

PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Data)

	September 30, 2011	December 31, 2010
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 19,538	$ 18,430
Restricted cash	468	1,853
Accounts receivable, net of allowance for doubtful accounts of $670 and $754 at September 30, 2011 and December 31, 2010, respectively	38,906	41,438
Inventories, net of reserves of $1,453 and $1,561 at September 30, 2011 and December 31, 2010, respectively	41,292	35,161
Assets of discontinued operations		2,776
Other receivables	11,034	14,539
Prepaid expenses and other current assets	4,710	3,580
Total current assets	115,948	117,777
PROPERTY AND EQUIPMENT, net	13,059	9,124
ASSETS OF DISCONTINUED OPERATIONS		1,126
OTHER ASSETS	2,200	2,203
Total assets	$ 131,207	$ 130,230
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital lease obligations	$ 18,259	$ 18,320
Trade accounts payable	55,007	55,692
Deferred revenue	6,481	5,254
Accrued expenses	17,987	15,870
Total current liabilities	97,734	95,136
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion	1,806	2,136
OTHER LIABILITIES	4,410	3,608
Total liabilities	103,950	100,880

COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS EQUITY:		
Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued and outstanding		
Common stock, $0.001 par value; 35,000,000 shares authorized; 12,782,712 and 12,255,064 shares issued at September 30, 2011 and December 31, 2010, respectively; and 12,764,351 and 12,236,703 outstanding at September 30, 2011 and December 31, 2010, respectively	13	12
Additional paid-in capital	104,298	101,229
Accumulated deficit	(78,658)	(73,332)
Accumulated other comprehensive income	1,689	1,526
Treasury stock at cost, 18,361 shares	(85)	(85)
Total shareholders equity	27,257	29,350
Total liabilities and shareholders equity	$ 131,207	$ 130,230

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

3

Table of Contents

PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED INTERIM
CONSOLIDATED STATEMENTS OF OPERATIONS
(In Thousands, Except Per Share Data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	**2010**	**2011**	**2010**
REVENUES:				
Product revenue, net	$ 37,923	$ 39,316	$ 122,005	$ 128,592
Service fee revenue	22,949	16,402	62,819	48,948
Pass-through revenue	9,999	7,842	26,444	20,662
Total revenues	70,871	63,560	211,268	198,202
COSTS OF REVENUES:				
Cost of product revenue	35,304	36,392	113,181	119,377
Cost of service fee revenue	17,663	11,981	47,241	35,422
Cost of pass-through revenue	9,999	7,842	26,444	20,662
Total costs of revenues	62,966	56,215	186,866	175,461
Gross profit	7,905	7,345	24,402	22,741
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES, including stock based compensation expense of $346 and $225 in the three months ended September 30, 2011 and 2010, respectively and $1,055 and $583 in the nine months ended September 30, 2011 and 2010, respectively	9,385	8,605	28,103	25,591
Loss from operations	(1,480)	(1,260)	(3,701)	(2,850)
INTEREST EXPENSE, net	308	250	769	738
Loss from continuing operations before income taxes	(1,788)	(1,510)	(4,470)	(3,588)
INCOME TAX EXPENSE	57	73	287	253
LOSS FROM CONTINUING OPERATIONS	(1,845)	(1,583)	(4,757)	(3,841)
INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF TAX	20	(337)	(569)	(783)
NET LOSS	$ (1,825)	$ (1,920)	$ (5,326)	$ (4,624)
LOSS PER SHARE FROM CONTINUING OPERATIONS:				
Basic	$ (0.15)	$ (0.13)	$ (0.38)	$ (0.35)
Diluted	$ (0.15)	$ (0.13)	$ (0.38)	$ (0.35)

LOSS PER SHARE INCLUDING DISCONTINUED OPERATIONS:				
Basic	$ (0.14)	$ (0.16)	$ (0.43)	$ (0.42)
Diluted	$ (0.14)	$ (0.16)	$ (0.43)	$ (0.42)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic	12,688	12,237	12,509	10,998
Diluted	12,688	12,237	12,509	10,998

The accompanying notes are an integral part of these unaudited interim condensed consolidated financial statements.

Table of Contents

PFSWEB, INC. AND SUBSIDIARIES
UNAUDITED INTERIM CONDENSED
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Thousands)

	Nine Months Ended September 30,	
	2011	**2010**
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (5,326)	$ (4,624)
Loss from discontinued operations	(569)	(783)
Loss from continuing operations	(4,757)	(3,841)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	4,575	4,593
Provision for doubtful accounts	(8)	110
Provision for excess and obsolete inventory	61	185
Deferred income taxes	92	(16)
Stock-based compensation expense	1,055	583
Changes in operating assets and liabilities:		
Restricted cash	87	14
Accounts receivable	2,628	4,690
Inventories, net	(7,054)	(641)
Prepaid expenses, other receivables and other assets	2,396	(311)
Accounts payable, deferred revenue, accrued expenses and other liabilities	3,103	(1,909)
Net cash provided by continuing operating activities	2,178	3,457
Net cash provided by (used in) discontinued operating activities	2,152	(408)
Net cash provided by operating activities	4,330	3,049
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(7,014)	(3,081)
Proceeds from sale of eCOST subsidiary	2,327	
Net cash used in investing activities	(4,687)	(3,081)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from issuance of common stock	2,015	7,271
Decrease in restricted cash	1,298	426
Payments on capital lease obligations	(793)	(968)
Payments on debt, net	(1,202)	(2,449)
Net cash provided by financing activities	1,318	4,280
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	147	(276)

NET INCREASE IN CASH AND CASH EQUIVALENTS	1,108	3,972
CASH AND CASH EQUIVALENTS, beginning of period	18,430	14,812
CASH AND CASH EQUIVALENTS, end of period	$ 19,538	$ 18,784
SUPPLEMENTAL CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Property and equipment acquired under debt and capital leases	$ 1,609	$ 635

The accompanying notes are an integral part of these unaudited interim condensed consolidated financial statements.

Table of Contents

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

1. OVERVIEW AND BASIS OF PRESENTATION

PFSweb, Inc. and its subsidiaries are collectively referred to as the Company; Supplies Distributors refers to Supplies Distributors, Inc. and its subsidiaries; Retail Connect refers to PFSweb Retail Connect, Inc.; and PFS refers to Priority Fulfillment Services, Inc. and its subsidiaries and affiliates, excluding Supplies Distributors and Retail Connect. In connection with the sale of certain of the assets of eCOST.com, Inc. (eCOST) described below, the name of eCOST was changed to PFSweb Retail Connect, Inc. in March 2011.

PFS Overview

PFS is an international business process outsourcing provider of end-to-end eCommerce solutions to major brand name companies seeking to optimize their supply chain and to enhance their traditional and online business channels and initiatives in the United States, Canada, and Europe. PFS offers a broad range of service offerings that include digital marketing, eCommerce technologies, order management, customer care, logistics and fulfillment, financial management and professional consulting.

Supplies Distributors Overview

Supplies Distributors, PFS and InfoPrint Solutions Company (IPS), a wholly-owned subsidiary of RICOH Company Limited (RICOH), have entered into master distributor agreements under which Supplies Distributors acts as a master distributor of various products, primarily IPS product.

Supplies Distributors has obtained certain financing that allows it to fund the working capital requirements for the sale of primarily IPS products. Pursuant to the transaction management services agreements between PFS and Supplies Distributors, PFS provides to Supplies Distributors transaction management and fulfillment services such as managed web hosting and maintenance, procurement support, web-enabled customer contact center services, customer relationship management, financial services including billing and collection services, information management, and international distribution services. Supplies Distributors does not have its own sales force and relies upon IPS sales force and product demand generation activities for its sale of IPS products. Supplies Distributors sells its products in the United States, Canada and Europe.

All of the agreements between PFS and Supplies Distributors were made in the context of a related party relationship and were negotiated in the overall context of PFS and Supplies Distributors arrangement with IPS. Although management believes that the terms of these agreements are generally consistent with fair market values, there can be no assurance that the prices charged to or by each company under these arrangements are not higher or lower than the prices that may be charged by, or to, unaffiliated third parties for similar services.

eCOST Overview

Until February 2011 the Company operated eCOST primarily as a multi-category online discount retailer of new, close-out and recertified brand-name merchandise, which sold products primarily to customers in the United States. In February 2011 the Company sold substantially all of the inventory and certain intangible assets of the eCOST discount retailer business unit for a cash purchase price of $2.3 million (before expenses of approximately $0.2 million) and the assumption by the purchaser of certain limited liabilities of eCOST. The purchase price represented approximately $1 million for inventory and the balance for the intangible assets. In connection with the closing of this business unit, the Company incurred exit costs of approximately $0.3 million related to employee termination costs, excess property

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

and equipment and certain contract termination costs and may incur additional costs, including excess facility costs. In December 2010, the Company recorded a non-cash goodwill impairment charge of approximately $2.8 million as a result of this sale. For all periods presented, the Company has reported the operating results of the eCOST discount retailer business unit, excluding costs expected to continue to occur in the future, as discontinued operations. The remaining assets and business operations of eCOST will be conducted under the name PFSweb Retail Connect and will continue to provide certain services, primarily under a product ownership based model, to certain of the Company s client relationships on an ongoing basis.

Basis of Presentation

The unaudited interim condensed consolidated financial statements as of September 30, 2011, and for the three and nine months ended September 30, 2011 and 2010, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and are unaudited. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations promulgated by the SEC. In the opinion of management and subject to the foregoing, the unaudited interim consolidated financial statements of the Company include all adjustments necessary for a fair presentation of the Company s financial position as of September 30, 2011, its results of operations for the three and nine months ended September 30, 2011 and 2010 and its cash flows for the nine months ended September 30, 2011 and 2010. Results of the Company s operations for interim periods may not be indicative of results for the full fiscal year.

Certain prior period data has been reclassified to conform to the current period presentation. These reclassifications had no effect on previously reported net income (loss) or total shareholders equity.

2. *SIGNIFICANT ACCOUNTING POLICIES*

Principles of Consolidation

All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements and related disclosures in conformity with generally accepted accounting principles requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. The recognition and allocation of certain revenues and selling, general and administrative expenses in these consolidated financial statements also require management estimates and assumptions.

Estimates and assumptions about future events and their effects cannot be determined with certainty. The Company bases its estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as the operating environment changes. These changes have been included in the consolidated financial statements as soon as they became known. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged periods of time. These uncertainties are discussed in this report and in the Company s Annual Report on Form 10-K for the year ended December 31, 2010 in the section entitled Risk Factors. Based on a critical assessment of accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes the Company s consolidated financial statements are fairly stated in accordance with generally accepted accounting principles in the United States of America, and provide a fair presentation of the Company s financial position and results of operations.

Table of Contents

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

Investment in Affiliates

PFS has made advances to Supplies Distributors that are evidenced by a Subordinated Demand Note (the Subordinated Note). Under the terms of certain of the Company s debt facilities, the outstanding balance of the Subordinated Note cannot be increased to more than $5.0 million or decreased to less than $3.5 million without prior approval of the Company s lenders. At September 30, 2011 and December 31, 2010, the outstanding balance of the Subordinated Note was $3.5 million in both periods. The Subordinated Note is eliminated in the Company s consolidated financial statements.

PFS has also made advances to Retail Connect, which aggregated $11.1 million as of both September 30, 2011 and December 31, 2010. Certain terms of the Company s debt facilities provide that the total advances to Retail Connect may not be less than $2.0 million without prior approval of Retail Connect s lender, if needed. PFSweb, Inc. has also advanced to Retail Connect an additional $7.7 million and $7.4 million as of September 30, 2011 and December 31, 2010, respectively. The PFS and PFSweb advances are eliminated in the Company s consolidated financial statements.

Concentration of Business and Credit Risk

The Company s service fee revenue is generated under contractual service fee relationships with multiple client relationships. No service fee client or product revenue customer exceeded 10% of the Company s consolidated total net revenue or accounts receivable during the nine months ended September 30, 2011. A summary of the nonaffiliated customer and client concentrations is as follows:

	Nine Months Ended September 30,	
	2011	**2010**
Product Revenue (as a percentage of Product Revenue):		
Customer 1	16%	17%
Customer 2	9%	10%
Service Fee Revenue (as a percentage of Service Fee Revenue):		
Client 1	15%	6%
Client 2	15%	7%
Client 3	1%	10%

PFS previously operated three distinct geographical contract arrangements with Client 3, which are aggregated in the service fee revenue percentages reflected above. As of September 30, 2010, substantially all of Client 3 s contracts with PFS had expired in accordance with their terms and were not renewed.

The Company has provided certain collateralized guarantees of its subsidiaries financings and credit arrangements. These subsidiaries ability to obtain financing on similar terms would be significantly impacted without these guarantees.

Supplies Distributors has multiple arrangements with International Business Machines Corporation (IBM) and IPS and is dependent upon the continuation of such arrangements. These arrangements, which are critical to Supplies Distributors ongoing operations, include master distributor agreements and certain working capital financing agreements. Substantially all of Supplies Distributors revenue is generated by its sale of product purchased from IPS. Supplies Distributors also relies upon IPS sales force and product demand generation activities and the discontinuance of such services would have a material impact upon Supplies Distributors business. In addition, Supplies Distributors has product sales to IBM and IPS business affiliates.

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

RICOH has advised Supplies Distributors that it is restructuring its IPS business which will include certain realignment and operational changes in the sale and distribution of IPS products. The Company is currently evaluating the impact of these changes to its business, though it believes the changes will result in reduced revenues and profitability for Supplies Distributors beginning in 2012.

Inventories

Inventories (all of which are finished goods) are stated at the lower of weighted average cost or market. The Company establishes inventory reserves based upon estimates of declines in values due to inventories that are slow moving or obsolete, excess levels of inventory or values assessed at lower than cost.

Supplies Distributors assumes responsibility for slow-moving inventory under its IPS master distributor agreements, subject to certain termination rights, but has the right to return product rendered obsolete by engineering changes, as defined. In the event PFS, Supplies Distributors and IPS terminate the master distributor agreements, the agreements provide for the parties to mutually agree on a plan of disposition of Supplies Distributors then existing inventory.

Property and Equipment

The Company s property held under capital leases amounted to approximately $2.4 million and $1.5 million, net of accumulated amortization of approximately $2.1 million and $2.8 million, at September 30, 2011 and December 31, 2010, respectively.

Income Taxes

The Company records a tax provision primarily associated with state income taxes and its Supplies Distributors subsidiary s international operations. The Company has recorded a valuation allowance for the majority of its net deferred tax assets.

Cash Paid for Interest and Taxes

The Company made payments for interest of approximately $0.8 million and $0.7 million in the nine months ended September 30, 2011 and 2010, respectively. Income taxes of approximately $0.4 million were paid by the Company during each of the nine month periods ended September 30, 2011 and 2010.

Impact of Recently Issued Accounting Standards

In June 2011, the Financial Accounting Standards Board issued new accounting guidance regarding the presentation of comprehensive income. The new guidance requires the presentation of items of net income and comprehensive income in either a single continuous financial statement or in two separate but consecutive financial statements. This account guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. The impact of adoption will not have a material effect on the Company s consolidated financial statements as it only requires a change in the format of the Company s current presentation.

3. *COMPREHENSIVE LOSS (in thousands)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	**2010**	**2011**	**2010**
Net loss	$ (1,825)	$ (1,920)	$ (5,326)	$ (4,624)
Other comprehensive income (loss):				
Foreign currency translation adjustment	(622)	871	163	(569)
Comprehensive loss	$ (2,447)	$ (1,049)	$ (5,163)	$ (5,193)

4. *NET LOSS PER COMMON SHARE*

Basic and diluted net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding for the reporting period. For the three and nine months ended September

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

30, 2011 and 2010, outstanding options to purchase common shares of 2.3 million in each period were anti-dilutive and have been excluded from the diluted weighted average share computation.

5. *STOCK AND STOCK OPTIONS*

In May 2010, the Company completed a public offering pursuant to which the Company issued and sold an aggregate of 2.3 million shares of common stock, par value $.001 per share, at $3.50 per share, resulting in net proceeds after deducting offering expenses of $7.3 million.

During the nine months ended September 30, 2011 and 2010, the Company issued an aggregate of 660,000 and 654,000 options, respectively, to purchase shares of common stock to officers, directors, employees and consultants of the Company.

6. *VENDOR FINANCING:*

Outstanding obligations under vendor financing arrangements consist of the following (in thousands):

	September 30, 2011	December 31, 2010
Inventory and working capital financing agreements:		
United States	$ 17,847	$ 16,472
Europe	16,052	11,318
Total	$ 33,899	$ 27,790

Inventory and Working Capital Financing Agreement, United States

Supplies Distributors has a short-term credit facility with IBM Credit LLC to finance its distribution of IPS products in the United States, providing financing for eligible IPS inventory and certain receivables up to $25.0 million through its expiration in March 2012. As of September 30, 2011, Supplies Distributors had $4.1 million of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among others, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including other direct or indirect Company subsidiaries), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors, as well as a collateralized guarantee of PFS and a Company parent guarantee. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of $3.5 million and the Company is required to maintain a minimum shareholders equity of $18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at prime rate plus 0.5% (3.75% as of September 30, 2011). The facility also includes a monthly service fee. Given the structure of this facility and as outstanding balances, which represent inventory purchases, are repaid within twelve months, the Company has classified the outstanding amounts under this facility as accounts payable in the consolidated balance sheets.

Inventory and Working Capital Financing Agreement, Europe

Supplies Distributors European subsidiary has a short-term credit facility with IBM Belgium Financial Services S.A. (IBM Belgium) to finance its distribution of IPS products in Europe. The asset based credit facility with IBM Belgium provides up to 16.0 million euros (approximately $21.6 million as of September 30, 2011) in inventory financing and cash advances based on eligible inventory and accounts receivable through its expiration in March 2012. As of September 30, 2011, Supplies Distributors European subsidiaries had 1.6 million euros (approximately $2.2 million) of available credit under this facility. The credit facility contains cross default provisions, various restrictions upon the ability of Supplies Distributors and its European subsidiary to, among others, merge, consolidate, sell assets, incur

10

Table of Contents

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

indebtedness, make loans and payments to related parties (including other direct or indirect Company subsidiaries), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as annualized revenue to working capital, net profit after tax to revenue, and total liabilities to tangible net worth, as defined, and are secured by certain of the assets of Supplies Distributors European subsidiary, as well as collateralized guaranties of Supplies Distributors and PFS and a Company parent guarantee. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of $3.5 million and the Company is required to maintain a minimum shareholders equity of $18.0 million. Borrowings under the credit facility accrue interest at Euribor plus 1.82% for cash advances, and, after a defined free financing period, at Euribor plus 4.1% for inventory financings. As of September 30, 2011, the interest rate was 5.5% on $7.5 million of outstanding inventory financings. Supplies Distributors European subsidiary pays a monthly service fee on the commitment. Given the structure of this facility and as outstanding inventory financing balances are repaid within twelve months, the Company has classified the outstanding inventory financing amounts under this facility as accounts payable in the consolidated balance sheets.

7. *DEBT AND CAPITAL LEASE OBLIGATIONS;*

Outstanding obligations under debt and capital lease obligations consist of the following (in thousands):

	September 30, 2011	December 31, 2010
Loan and security agreements, United States		
Supplies Distributors	$ 7,032	$ 7,220
PFS	6,350	6,000
Credit facility Retail Connect		
Factoring agreement, Europe	1,702	2,302
Taxable revenue bonds	800	1,600
Master lease agreements	2,946	2,660
Other	1,235	674
Total	20,065	20,456
Less current portion of long-term debt	18,259	18,320
Long-term debt, less current portion	$ 1,806	$ 2,136

Loan and Security Agreement Supplies Distributors

Supplies Distributors has a loan and security agreement with Wells Fargo Bank, National Association (Wells Fargo) to provide financing for up to $25 million of eligible accounts receivable in the United States and Canada. As of September 30, 2011, based on the available borrowing collateral balances, Supplies Distributors had $1.2 million of available credit under this agreement. The Wells Fargo facility expires on the earlier of March 2014 or the date on which the parties to the IPS master distributor agreement no longer operate under the terms of such agreement and/or IPS no longer supplies products pursuant to such agreement. Borrowings under the Wells Fargo facility accrue interest at prime rate plus 0.25% to 0.75% (3.75% as of September 30, 2011) or Eurodollar rate plus 2.5% to 3.0%, dependent on excess availability and subject to a minimum of 3.0%, as defined. The interest rate as of September 30, 2011 was 3.75% for $5.0 million of outstanding borrowings and 3.0% for $2.0 million of outstanding borrowings. This agreement contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including other direct or indirect Company subsidiaries), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends, as well as financial covenants, such as minimum net

worth, as defined, and is secured by all of the assets of Supplies Distributors, as well as a collateralized guarantee of PFS and a Company parent guarantee. Additionally, PFS is required to maintain a Subordinated Note receivable balance from Supplies Distributors of no less than $3.5 million and may not maintain restricted cash of more than $5.0 million, and is restricted with regard to transactions with related parties, indebtedness and changes to

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

capital stock ownership structure. Supplies Distributors has entered into blocked account agreements with its banks and Wells Fargo pursuant to which a security interest was granted to Wells Fargo for all U.S. and Canadian customer remittances received in specified bank accounts. At September 30, 2011 and December 31, 2010, these bank accounts held $0.2 million and $0.8 million, respectively, which was restricted for payment to Wells Fargo.

Loan and Security Agreement PFS

PFS has a Loan and Security Agreement (Comerica Agreement) with Comerica Bank (Comerica). The Comerica Agreement provides for up to $10.0 million of eligible accounts receivable financing through September 2012. The Comerica Agreement also allows for up to $12.5 million of eligible accounts receivable financing during certain seasonal peak months. As of September 30, 2011, PFS had $3.6 million of available credit under this facility. Borrowings under the Comerica Agreement accrue interest at a defined rate, which will generally be prime rate plus 2%, with a minimum of 4.5% (5.25% at September 30, 2011). The Comerica Agreement contains cross default provisions, various restrictions upon PFS ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including other direct or indirect Company subsidiaries), make capital expenditures, make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of $20 million, as defined, a minimum earnings before interest and taxes, plus depreciation, amortization and non-cash compensation accruals, if any, as defined, and a minimum liquidity ratio, as defined. The Comerica Agreement restricts the amount of the Subordinated Note receivable from Supplies Distributors to a maximum of $5.0 million. Comerica has provided approval for PFS to advance incremental amounts subject to certain cash inflows to PFS, as defined, to certain of its subsidiaries and/or affiliates, if needed. The Comerica Agreement is secured by all of the assets of PFS, as well as a Company parent guarantee.

On November 10, 2011, PFS entered into an amended agreement with Comerica to also provide for up to $2.5 million of eligible equipment purchases (Equipment Advances). Outstanding Equipment Advances under the amended Comerica Agreement accrue interest at prime rate plus 2.25% and have a final maturity date of April 15, 2015.

Credit Facility Retail Connect

Retail Connect has an asset-based line of credit facility of up to $7.5 million from Wells Fargo Bank, National Association (Wells Fargo), through May 2012, which is collateralized by substantially all of Retail Connect s assets. Borrowings under the facility are limited to a percentage of eligible accounts receivable and inventory up to a specified amount. Outstanding borrowings under the facility bear interest at prime rate plus 1% or Eurodollar rate plus 3.5%. There were no outstanding borrowings as of September 30, 2011. As of September 30, 2011, Retail Connect had $0.1 million of letters of credit outstanding and $0.1 million of available credit under this facility. Subsequent to the sale of certain assets in February 2011, amounts available under the outstanding letter of credit are secured by restricted cash in equivalent amounts until expiration. In connection with the line of credit, Retail Connect entered into a cash management arrangement whereby Retail Connect s operating accounts are considered restricted and swept and used to repay outstanding amounts under the line of credit, if any. As of September 30, 2011 and December 31, 2010, the restricted cash amount was $0.1 million and $0.2 million, respectively. The credit facility restricts Retail Connect s ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties (including other direct or indirect Company subsidiaries), make investments and loans, pledge assets, make changes to capital stock ownership structure, and requires a minimum tangible net worth for Retail Connect of $0 million, as defined. The Company has guaranteed all current and future obligations of Retail Connect under this line of credit.

Factoring Agreement

Supplies Distributors European subsidiary has a factoring agreement with BNP Paribas Fortis that provides factoring for up to 7.5 million euros (approximately $10.1 million as of September 30, 2011) of eligible accounts receivables through March 2014. This factoring agreement is accounted for as a secured borrowing. Borrowings accrue interest at Euribor plus 0.7% (2.0% at September 30, 2011). This agreement contains certain financial covenants, including minimum tangible net worth.

12

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

Taxable Revenue Bonds

PFS has a Loan Agreement with the Mississippi Business Finance Corporation (the MBFC) in connection with the issuance by the MBFC of MBFC Taxable Variable Rate Demand Limited Obligation Revenue Bonds, Series 2004 (Priority Fulfillment Services, Inc. Project) (the Bonds). The MBFC loaned the proceeds of the Bonds to PFS for the purpose of financing the acquisition and installation of equipment, machinery and related assets located in one of the Company s Southaven, Mississippi distribution facilities. The Bonds bear interest at a variable rate (0.3% as of September 30, 2011), as determined by Comerica Securities, as Remarketing Agent. PFS, at its option, may convert the Bonds to a fixed rate, to be determined by the Remarketing Agent at the time of conversion.

The primary source of repayment of the Bonds is a letter of credit (the Letter of Credit) issued by Comerica pursuant to a Reimbursement Agreement between PFS and Comerica under which PFS is obligated to pay to Comerica all amounts drawn under the Letter of Credit. The Letter of Credit has a maturity date of April 2012. The Bonds require a final principal repayment of $800,000 in January of 2012. PFS obligations under the Reimbursement Agreement are secured by substantially all of the assets of PFS and a Company parent guarantee.

Debt Covenants

To the extent the Company or any of its subsidiaries fail to comply with covenants applicable to its debt or vendor financing obligations, including the monthly financial covenant requirements and required level of shareholders equity or net worth, and one or all of the lenders accelerate the repayment of the credit facility obligations, the Company would be required to repay all amounts outstanding thereunder. In particular, if PFS service fee revenue declines from expected levels and it is unable to reduce costs to correspond to such reduced revenue levels or if Supplies Distributors revenue or gross profit declines from expected levels, such events may result in a breach of one or more of the financial covenants required under its working capital line of credit. In such event, absent a waiver, the working capital lender would be entitled to accelerate all amounts outstanding thereunder and exercise all other rights and remedies, including sale of collateral and demand for payment under the Company parent guarantee. Any acceleration of the repayment of the credit facilities would have a material adverse impact on the Company s financial condition and results of operations and no assurance can be given that the Company would have the financial ability to repay all of such obligations. As of September 30, 2011, the Company was in compliance with all debt covenants.

Master Lease Agreements

The Company has a Term Lease Master Agreement with IBM Credit Corporation (Master Lease Agreement) that provides for leasing or financing transactions of equipment and other assets, which generally have terms of three years. The amounts outstanding under this Master Lease Agreement ($0.5 million as of September 30, 2011 and $1.0 million as of December 31, 2010) are secured by the related equipment and a Company parent guarantee.

The Company has other leasing and financing agreements and will continue to enter into such arrangements as needed to finance the purchasing or leasing of certain equipment or other assets. Borrowings under these agreements are generally secured by the related equipment, and in certain cases, by a Company parent guarantee.

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

8. *SEGMENT INFORMATION*

The Company is currently organized into two primary operating segments, which generally align with the corporate organization structure. In the first segment, PFS is an international provider of various business process outsourcing solutions and operates as a service fee business. In the second operating segment (Business and Retail Connect), subsidiaries of the Company purchase inventory from clients and resell the inventory to client customers. In this segment, the Company generally recognizes product revenue.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues (in thousands):				
PFS	$ 34,466	$ 25,729	$ 94,034	$ 74,551
Business and Retail Connect	37,923	39,316	122,005	128,592
Eliminations	(1,518)	(1,485)	(4,771)	(4,941)
	$ 70,871	$ 63,560	$ 211,268	$ 198,202
Income (loss) from continuing operations (in thousands):				
PFS	$ (2,031)	$ (2,015)	$ (5,794)	$ (5,027)
Business and Retail Connect	186	432	1,037	1,186
	$ (1,845)	$ (1,583)	$ (4,757)	$ (3,841)
Depreciation and amortization (in thousands):				
PFS	$ 1,529	$ 1,452	$ 4,553	$ 4,572
Business and Retail Connect	8	7	22	21
	$ 1,537	$ 1,459	$ 4,575	$ 4,593
Capital expenditures (in thousands):				
PFS	$ 2,981	$ 1,132	$ 6,977	$ 2,986
Business and Retail Connect	17	73	37	95
	$ 2,998	$ 1,205	$ 7,014	$ 3,081

	September 30, 2011	December 31, 2010
Assets (in thousands):		
PFS	$ 70,905	$ 62,617
Business and Retail Connect	75,397	82,175
Eliminations	(15,095)	(14,562)
	$ 131,207	$ 130,230

9. *COMMITMENTS AND CONTINGENCIES*

The Company receives municipal tax abatements in certain locations. During 2004 the Company received notice from a municipality that it did not satisfy certain criteria necessary to maintain the abatements. In December 2006, the Company received notice that the municipal authority planned to make an adjustment to the Company s tax abatement. The Company disputed the adjustment and such dispute has been settled with the municipality. However, the amount of additional property taxes to be assessed against the Company and the timing of the related payments has not been finalized. As of September 30, 2011, the Company believes it has adequately accrued for the expected assessment.

In April 2010, a sales employee of eCOST was charged with violating various federal criminal statutes in connection with the sales of eCOST products to certain customers, and approximately $620,000 held in an eCOST deposit account was seized and turned over to the Office of the U.S. Attorney in connection

PFSweb, Inc. and Subsidiaries
Notes to Unaudited Interim Consolidated Financial Statements

with such activity. The Company received subpoenas from the Office of the U.S. Attorney requesting information regarding the employee and other matters, and the Company has responded to the subpoenas and is fully cooperating with the Office of the U.S. Attorney. The Company has commenced its own investigation into the actions of the employee. Neither the Company nor eCOST have been charged with any criminal activity, and the Company intends to seek the recovery or reimbursement of the funds which are currently classified as other receivables in the September 30, 2011 financial statements. Based on the information available to date, the Company is unable to determine the amount of the loss, if any, relating to the seizure of such funds. No assurance can be given, however, that the seizure of such funds, or the inability of the Company to recover such funds or any significant portion thereof, or any costs and expenses incurred by the Company in connection with this matter will not have a material adverse effect upon the Company s financial condition or results of operations.

The Company is subject to claims in the ordinary course of business, including claims of alleged infringement by the Company or its subsidiaries of the patents, trademarks and other intellectual property rights of third parties. PFS is generally required to indemnify its service fee clients against any third party claims alleging infringement by PFS of the patents, trademarks and other intellectual property rights of third parties.

10. *DISCONTINUED OPERATIONS*

In February 2011, the Company sold certain assets of eCOST to a third party for a total aggregate cash purchase price of approximately $2.3 million (before expenses of approximately $0.2 million). Accordingly, the accompanying consolidated financial statements reflect the related operating results of the eCOST segment as discontinued operations for all periods presented.

Summarized financial information in the accompanying consolidated statements of operations for the discontinued eCOST operations is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30	
	2011	2010	2011	2010
Revenue, net	$ 47	$ 16,408	$ 6,858	$ 52,490
Expenses	27	16,742	7,418	53,246
Income (loss) before provision for income taxes	20	(334)	(560)	(756)
Provision for income taxes		(3)	(9)	(27)
Discontinued operations, net of income taxes	$ 20	$ (337)	$ (569)	$ (783)

Summarized financial information in the accompanying consolidated balance sheet for the discontinued eCOST operations, which were sold in February 2011, is as follows (in thousands):

	December 31, 2010
Inventories, net	$ 2,776
Identifiable intangibles	316
Goodwill	810
Assets of discontinued operations	$ 3,902

At December 31, 2010, the amount of allowance for slow moving inventory included in discontinued operations was $0.2 million.

The original eCOST acquisition resulted in a purchase price in excess of the fair value of net identifiable assets acquired and liabilities assumed. This excess purchase price was allocated to goodwill. Goodwill, which is not deductible for tax purposes, is not amortized yet is subject to an annual impairment test, using a fair-value-based approach. The remaining balance of goodwill, $0.8 million as of December 31, 2010, was included in assets of discontinued operations.

Table of Contents

ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our results of operations and financial condition should be read in conjunction with the unaudited interim condensed consolidated financial statements and related notes appearing elsewhere in this Form 10-Q.

Forward-Looking Information

We have made forward-looking statements in this Report on Form 10-Q. These statements are subject to risks and uncertainties, and there can be no guarantee that these statements will prove to be correct. Forward-looking statements include assumptions as to how we may perform in the future. When we use words like seek, strive, believe, expect, anticipate, predict, potential, continue, will, may, could, intend, plan, target and estimate or si are making forward-looking statements. You should understand that the following important factors, in addition to those set forth above or elsewhere in this Report on Form 10-Q and our Form 10-K for the year ended December 31, 2010, could cause our results to differ materially from those expressed in our forward-looking statements. These factors include:

- our ability to retain and expand relationships with existing clients and attract and implement new clients;
- our reliance on the fees generated by the transaction volume or product sales of our clients;
- our reliance on our clients projections or transaction volume or product sales;
- our Supplies Distributors subsidiary s dependence upon its agreements with International Business Machines Corporation (IBM) and InfoPrint Solutions Company (IPS);
- our dependence upon our agreements with our major clients;
- our client mix, their business volumes and the seasonality of their business;
- our ability to finalize pending contracts;
- the impact of strategic alliances and acquisitions;
- trends in e-commerce, outsourcing, government regulation both foreign and domestic and the market for our services;
- whether we can continue and manage growth;
- increased competition;
- our ability to generate more revenue and achieve sustainable profitability;
- effects of changes in profit margins;
- the customer and supplier concentration of our business;
- the reliance on third-party subcontracted services;
- the unknown effects of possible system failures and rapid changes in technology;
- foreign currency risks and other risks of operating in foreign countries;

potential litigation;

our dependency on key personnel;

the impact of new accounting standards, and changes in existing accounting rules or the interpretations of those rules;

our ability to raise additional capital or obtain additional financing;

our ability and the ability of our subsidiaries to borrow under current financing arrangements and maintain compliance with debt covenants;

relationship with and our guarantees of certain of the liabilities and indebtedness of our subsidiaries; and

taxation on the sale of our products.

We have based these statements on our current expectations about future events. Although we believe that the expectations reflected in our forward-looking statements are reasonable, we cannot guarantee these expectations actually will be achieved. In addition, some forward-looking statements are based upon assumptions as to future events that may not prove to be accurate. Therefore, actual outcomes and results may differ materially from what is expected or forecasted in such forward-looking statements. We undertake no obligation to update publicly any forward-looking statement for any reason, even if new information becomes available or other events occur in the future.

Table of Contents

Overview

We are an international business process outsourcing provider of end-to-end eCommerce solutions. We provide these solutions to major brand name companies seeking to optimize their supply chain and to enhance their traditional and online business channels and initiatives. We derive our revenues from providing a broad range of services as we process individual business transactions on our clients behalf using three different seller services financial models: 1) the Enablement model, 2) the Agent (or Flash) model and 3) the Retail model.

We refer to the standard PFS seller services financial model as the Enablement model. In this model, our clients own the inventory and are the merchants of record and engage us to provide various business outsourcing services in support of their business operations. We derive our service fee revenues from a broad range of service offerings that include digital marketing, eCommerce technologies, order management, customer care, logistics and fulfillment, financial management and professional consulting. We offer our services as an integrated solution, which enables our clients to outsource their complete infrastructure needs to a single source and to focus on their core competencies. Our distribution services are conducted at warehouses we lease or manage. We currently provide infrastructure and distribution solutions to clients that operate in a range of vertical markets, including technology manufacturing, computer products, cosmetics, fragile goods, contemporary home furnishings, apparel, aviation, telecommunications, consumer electronics and consumer packaged goods, among others.

In this model, we typically charge for our services on a cost-plus basis, a percent of shipped revenue basis or a per-transaction basis, such as a per-minute basis for web-enabled customer contact center services and a per-item basis for fulfillment services. Additional fees are billed for other services. We price our services based on a variety of factors, including the depth and complexity of the services provided, the amount of capital expenditures or systems customization required, the length of contract and other factors.

Many of our service fee contracts involve third-party vendors who provide additional services such as package delivery. The costs we are charged by these third-party vendors for these services are often passed on to our clients. Our billings for reimbursements of these costs and other out-of-pocket expenses include travel, shipping and handling costs and telecommunication charges and are included in pass-through revenue.

As an additional service, we offer our second model, the Agent, or Flash, financial model, in which our clients maintain ownership of the product inventory stored at our locations as in the Enablement model. When a customer orders the product from our clients, a flash sale transaction passes product ownership to us for each order and we, in turn, immediately re-sell the product to the customer. The flash ownership exchange establishes us as the merchant of record, which enables us to use our existing merchant infrastructure to process sales to end customers, removing the need for the clients to establish these business processes internally, but permitting them to control the sales process to end customers. In this model, based on the terms of our current client arrangements, we record product revenue on a net basis.

Finally, our Retail model allows us to purchase inventory from the client just as any other client reseller partner. In this model, we place the initial and replenishment purchase orders with the client and take ownership of the product upon delivery to our facility. Consequently, in this model, we generate product revenue as we own the inventory and the accounts receivable arising from our product sales. Under the Retail model, depending upon the product category and sales characteristics, we may require the client to provide product price protection as well as product purchase payment terms, right of return, and obsolescence protection appropriate to the product sales profile. In this model we recognize product revenue for customer sales. Freight costs billed to customers are reflected as components of product revenue. This business model requires significant working capital requirements, for which we have credit available either through credit terms provided by our client or under senior credit facilities.

In general, we provide the Enablement model through our PFS and Supplies Distributors subsidiaries, the Agent or Flash model through our PFS and Supplies Distributors subsidiaries and the Retail model

through our Supplies Distributors subsidiaries and our Retail Connect subsidiary. In connection with the sale of certain of the assets of eCOST.com (eCOST), the name of eCOST was changed to PFSweb Retail Connect, Inc., in March 2011.

Growth is a key element to achieving our future goals, including achieving and maintaining sustainable profitability. Growth in our Enablement and Agent models is driven by two main elements: new client relationships and organic growth from existing clients. We focus our sales efforts on larger contracts with brand-name companies within two primary target markets, online brands and retailers and technology manufacturers, which, by nature, require a longer duration to close but also have the potential to be higher-quality and longer duration engagements.

Growth within our Retail model is currently primarily driven by our ability to attract new master distributor arrangements with InfoPrint Solutions Company (IPS), a wholly-owned subsidiary of RICOH Company Limited (RICOH), or other manufacturers and the sales and marketing efforts of the manufacturers and third party sales partners. RICOH has advised us that it is restructuring its IPS business, which will include certain realignment and operational changes in the sale and distribution of IPS products. We are currently evaluating the impact of these changes to our business, though we believe the changes will result in reduced revenues and profitability under our Retail model beginning in 2012.

We continue to monitor and control our costs to focus on profitability. While we are targeting our new service fee contracts to yield incremental gross profit, we also expect to incur incremental investments in technology development, operational and support management and sales and marketing expenses.

Our expenses comprise primarily four categories: 1) cost of product revenue, 2) cost of service fee revenue, 3) cost of pass-through revenue and 4) selling, general and administrative expenses.

Cost of product revenues consists of the purchase price of product sold and freight costs, which are reduced by certain reimbursable expenses. These reimbursable expenses include pass-through customer marketing programs, direct costs incurred in passing on any price decreases offered by vendors to cover price protection and certain special bids, the cost of products provided to replace defective product returned by customers and certain other expenses as defined under the master distributor agreements.

Cost of service fee revenue consists primarily of compensation and related expenses for our web-enabled customer contact center services, international fulfillment and distribution services and professional consulting services, and other fixed and variable expenses directly related to providing services under the terms of fee based contracts, including certain occupancy and information technology costs and depreciation and amortization expenses.

Cost of pass-through revenue the related reimbursable costs for pass-through expenditures are reflected as cost of pass-through revenue.

Selling, General and Administrative expenses consist of expenses such as compensation and related expenses for sales and marketing staff, distribution costs (excluding freight) applicable to the Supplies Distributors business and the Retail model, executive, management and administrative personnel and other overhead costs, including certain occupancy and information technology costs and depreciation and amortization expenses.

Monitoring and controlling our available cash balances and our expenses continues to be a primary focus. Our cash and liquidity positions are important components of our financing of both current operations and our targeted growth. To aid this, in May 2010, we completed a public offering of 2.3 million shares of our common stock that provided net proceeds of $7.3 million.

Table of Contents

Results of Operations
For the Interim Periods Ended September 30, 2011 and 2010

The results of operations related to the eCOST business unit that was sold in February 2011 have been reported as discontinued operations for all periods presented below. The following table discloses certain financial information for the periods presented, expressed in terms of dollars, dollar change, percentage change and as a percentage of total revenue (in millions):

	Three Months Ended September 30,					Nine Months Ended September 30,				
				% of Net Revenues					% of Net Revenues	
Revenues:	2011	2010	Change	2011	2010	2011	2010	Change	2011	2010
Product revenue, net	$ 37.9	$ 39.3	$ (1.4)	53.5%	61.9%	$ 122.0	$ 128.6	$ (6.6)	57.8%	64.9%
Service fee revenue	23.0	16.4	6.6	32.4%	25.8%	62.8	48.9	13.9	29.7%	24.7%
Pass-through revenue	10.0	7.9	2.1	14.1%	12.3%	26.4	20.7	5.7	12.5%	10.4%
Total net revenues	70.9	63.6	7.3	100.0%	100.0%	211.2	198.2	13.0	100.0%	100.0%
Cost of Revenues										
Cost of product revenue (1)	35.3	36.4	(1.1)	93.1%	92.6%	113.2	119.4	(6.2)	92.8%	92.8%
Cost of service fee revenue (2)	17.7	11.9	5.8	77.0%	73.0%	47.2	35.4	11.8	75.2%	72.4%
Pass-through cost of revenue (3)	10.0	7.9	2.1	100.0%	100.0%	26.4	20.7	5.7	100.0%	100.0%
Total cost of revenues	63.0	56.2	6.8	88.8%	88.4%	186.8	175.5	11.3	88.5%	88.5%
Product revenue gross profit	2.6	2.9	(0.3)	6.9%	7.4%	8.8	9.2	(0.4)	7.2%	7.2%
Service fee gross profit	5.3	4.5	0.8	23.0%	27.0%	15.6	13.5	2.1	24.8%	27.6%
Pass-through gross profit				%	%				%	%
Total gross profit	7.9	7.4	0.5	11.2%	11.6%	24.4	22.7	1.7	11.4%	11.5%
Selling, General and Administrative expenses	9.4	8.6	0.8	13.2%	13.4%	28.1	25.6	2.5	13.3%	12.9%
Loss from operations	(1.5)	(1.2)	(0.3)	(2.0)%	(1.8)%	(3.7)	(2.9)	(0.8)	(1.9)%	(1.4)%
Interest expense, net	0.3	0.3		0.4%	0.4%	0.8	0.7	0.1	0.4%	%

Loss from continuing operations before income taxes	(1.8)	(1.5)	(0.3)	(2.4)%	(2.2)%	(4.5)	(3.6)	(0.9)	(2.3)%	(1.8)%
Income tax expense, net		0.1	0.1	0.2%	(0.2)%	0.3	0.2	0.1	0.1%	0.1%
Loss from continuing operations	(1.8)	(1.6)	(0.2)	(2.6)%	(2.4)%	(4.8)	(3.8)	(1.0)	(2.2)%	(1.9)%
Income (loss) from discontinued operations, net of tax		(0.3)	0.3	0.1%	(1.2)%	(0.5)	(0.8)	0.3	(0.3)%	(0.4)%
Net loss	$ (1.8)	$ (1.9)	$ 0.1	(2.5)%	(4.6)%	$ (5.3)	$ (4.6)	$ (0.7)	(2.5)%	(2.3)%

(1) % of net revenues represents the percent of Product revenue, net.

(2) % of net revenues represents the percent of Service fee revenue.

(3) % of net revenues represents the percent of Pass-through revenue.

Product Revenue, net. Product revenue was $37.9 million for the three months ended September 30, 2011, which represents a decrease of $1.4 million or 3.5% as compared to the same quarter of the prior year. Product revenue in the nine months ended September 30, 2011 decreased $6.6 million to $122.0 million or 5.1% compared to the nine months ended September 30, 2010. The decrease was primarily due to the impact of lower sales volume, partially offset by increased unit pricing on certain products, changes in end-user customer utilization and the impact of euro currency conversion rates. We currently expect 2011 annual product revenue to be slightly lower than in 2010.

RICOH has advised Supplies Distributors that it is restructuring its IPS business which will include certain operational changes in the sale and distribution of IPS products. We are currently evaluating the impact of these changes to our business, though we believe the changes will result in reduced revenues and profitability for Supplies Distributors beginning in 2012.

Service Fee Revenue. Service fee revenue of $23.0 million increased $6.6 million, or 39.9%, in the three months ended September 30, 2011 as compared to the same quarter of the prior year. Service fee revenue in the nine months ended September 30, 2011 increased $13.9 million to $62.8 million or 28.3% compared to the corresponding nine months in the prior year period. The increase in service fee revenue for the three and nine months ended September 30, 2011 is primarily due to increased service fees from existing client relationships along with service fees from new client relationships that began in late 2010 and early 2011 partially offset by the impact of terminated clients.

The change in service fee revenue is shown below ($ millions):

	Three Months	Nine Months
Period ended September 30, 2010	$ 16.4	$ 48.9
New service contract relationships	4.1	8.7
Change in existing client service fees	3.4	10.4
Terminated clients not included in 2011 revenue	(0.9)	(5.2)
Period ended September 30, 2011	$ 23.0	$ 62.8

Cost of Product Revenue. The cost of product revenue decreased by $1.1 million, or 3.0%, to $35.3 million in the three months ended September 30, 2011. The resulting gross profit margin was $2.6 million, or 6.9% of product revenue, for the three months ended September 30, 2011 and $2.9 million, or 7.4% of product revenue, for the comparable 2010 period. The cost of product revenue in the nine months ended September 30, 2011 decreased $6.2 million, or 5.2%, compared to the nine months ended September 30, 2010. The gross profit margin was $8.8 million, or 7.2%, in the nine months ended September 30, 2011 compared to $9.2 million, or 7.2%, in the same period of the prior year. The three and nine month periods ended September 30, 2011 and 2010 include the impact of certain incremental gross margin earned on product sales resulting from certain product price increases and the impact of certain incremental inventory cost reductions.

Cost of Service Fee Revenue. Gross profit as a percentage of service fees was 23.0% in three month period ended September 30, 2011 and 27.0% in the same period of 2010. Gross profit as a percentage of service fees in the nine months ended September 30, 2011 and 2010 was 24.8% and 27.6%, respectively. The gross profit percentage decrease is primarily due to a change in the client mix, lower gross margins on certain new and/or high growth clients, including certain start up costs and the impact of incremental costs incurred in implementing processes targeted to drive future long-term operating efficiencies. The margin in the prior year period includes the benefit of certain higher margin incremental project work.

We target to earn an overall average gross profit of 25-30% on existing and new service fee contracts, but we have and may continue to accept lower gross margin percentages on certain contracts depending on contract scope and other factors including projected volumes.

Selling, General and Administrative Expenses. Selling, General and Administrative expenses for the three months ended September 30, 2011 and 2010 were $9.4 million and $8.6 million, respectively. In the nine months ended September 30, 2011 and 2010 selling, general and administrative expenses were $28.1 million and $25.6 million, respectively. As a percentage of total net revenue, selling, general and administrative expenses were 13.2% in the three months ended September 30, 2011 and 13.4% in the prior year period. Selling, general and administrative expenses were 13.3% and 12.9% in the nine months ended September 30, 2011 and 2010, respectively. The increase in costs is primarily attributable to increased non-cash stock compensation expense, sales and marketing costs and personnel related expenses as we continue to make investments to support current and future growth. In addition, during the three months ended September 30, 2011, we incurred approximately $0.3 million of incremental relocation related costs necessary to support our growth. Due to planned facility expansions and relocation, we expect to incur certain ongoing incremental relocation related costs during the next several quarters into mid-2012. The three and nine months ended September 30, 2010 also included the impact of certain executive disability benefit costs that did not

occur in 2011.

Income Taxes.