

PFSWEB INC
Form 10-Q
November 10, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2016

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 000-28275

PFSweb, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State of Incorporation)

75-2837058
(I.R.S. Employer I.D. No.)

505 Millennium Drive, Allen, Texas 75013
(Address of principal executive offices) (Zip Code)

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

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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 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 No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller Reporting Company

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

At November 5, 2016 there were 18,706,633 shares of registrant's common stock outstanding.

PFSWEB, INC. AND SUBSIDIARIES

Form 10-Q

September 30, 2016

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

PFSweb, Inc. and Subsidiaries

CONDENSED CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)

	(Unaudited)	
	September 30, 2016	December 31, 2015
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 15,699	\$ 21,781
Restricted cash	219	275
Accounts receivable, net of allowance for doubtful accounts of \$539 and \$600 at September 30, 2016 and December 31, 2015, respectively	64,934	70,700
Inventories, net of reserves of \$585 and \$739 at September 30, 2016 and December 31, 2015, respectively	7,155	9,262
Other receivables	4,821	8,704
Prepaid expenses and other current assets	5,017	5,662
Total current assets	97,845	116,384
PROPERTY AND EQUIPMENT, net	28,812	24,093
IDENTIFIABLE INTANGIBLES, net	8,125	8,810
GOODWILL	45,929	39,829
OTHER ASSETS	2,433	2,174
Total assets	\$ 183,144	\$ 191,290
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital lease obligations	\$ 5,672	\$ 3,153
Trade accounts payable	38,009	51,170
Deferred revenue	6,238	7,390
Performance-based contingent payments	—	11,679
Accrued expenses	25,109	30,563
Total current liabilities	75,028	103,955
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less		
current portion	54,749	32,238
DEFERRED REVENUE	4,280	4,499
DEFERRED RENT	4,849	4,362
PERFORMANCE-BASED CONTINGENT PAYMENTS	380	2,478

Total liabilities	139,286	147,532
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY:		
Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued or outstanding	—	—
Common stock, \$0.001 par value; 35,000,000 shares authorized; 18,740,100 and 18,136,218 shares issued at September 30, 2016 and December 31, 2015, respectively; and 18,706,633 and 18,102,751 outstanding at September 30, 2016 and December 31, 2015, respectively	19	18
Additional paid-in capital	145,045	141,948
Accumulated deficit	(101,760)	(97,787)
Accumulated other comprehensive income (loss)	679	(296)
Treasury stock at cost, 33,467 shares	(125)	(125)
Total shareholders' equity	43,858	43,758
Total liabilities and shareholders' equity	\$ 183,144	\$ 191,290

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

PFSWEB, INC. AND SUBSIDIARIES

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands, Except Per Share Data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
REVENUES:				
Service fee revenue	\$ 53,788	\$ 45,528	\$ 154,271	\$ 121,311
Product revenue, net	11,671	14,419	36,658	44,731
Pass-through revenue	14,451	11,236	41,259	32,163
Total revenues	79,910	71,183	232,188	198,205
COSTS OF REVENUES:				
Cost of service fee revenue	36,903	30,193	103,547	81,993
Cost of product revenue	10,994	13,702	34,649	42,321
Cost of pass-through revenue	14,451	11,236	41,259	32,163
Total costs of revenues	62,348	55,131	179,455	156,477
Gross profit	17,562	16,052	52,733	41,728
SELLING, GENERAL AND ADMINISTRATIVE				
EXPENSES, including stock based compensation of \$347				
and \$1,492 for the three months ended September 30, 2016				
and 2015, respectively, and \$1,743 and \$3,446 for the nine				
months ended September 30, 2016 and 2015, respectively	17,568	18,778	53,926	47,068
Loss from operations	(6)	(2,726)	(1,193)	(5,340)
INTEREST EXPENSE, net	714	706	1,807	1,247
Loss from operations before income taxes	(720)	(3,432)	(3,000)	(6,587)
INCOME TAX EXPENSE, net	319	238	973	676
NET LOSS	\$(1,039)	\$(3,670)	\$(3,973)	\$(7,263)
NET LOSS PER SHARE:				
Basic	\$(0.06)	\$(0.21)	\$(0.21)	\$(0.42)
Diluted	\$(0.06)	\$(0.21)	\$(0.21)	\$(0.42)
WEIGHTED AVERAGE NUMBER OF SHARES				
OUTSTANDING:				
Basic	18,699	17,829	18,552	17,449
Diluted	18,699	17,829	18,552	17,449
COMPREHENSIVE LOSS:				
Net loss	\$(1,039)	\$(3,670)	\$(3,973)	\$(7,263)
Foreign currency translation adjustment	680	(89)	976	(757)
TOTAL COMPREHENSIVE LOSS	\$(359)	\$(3,759)	\$(2,997)	\$(8,020)

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

PFSweb, Inc. and Subsidiaries

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

	Nine Months Ended September 30,	
	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$(3,973)	\$(7,263)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	11,206	10,645
Amortization of debt issuance costs	109	—
Provision for doubtful accounts	16	53
Provision for excess and obsolete inventory	21	75
Deferred income taxes	57	125
Stock-based compensation expense	1,743	3,446
Non-cash compensation expense	—	131
Change in performance-based contingent payments	(2,638)	403
Changes in operating assets and liabilities:		
Restricted cash	—	34
Accounts receivable	7,651	13,077
Inventories	2,106	1,690
Prepaid expenses, other receivables and other assets	4,843	4,583
Deferred rent	906	(421)
Accounts payable, deferred revenue, accrued expenses and other liabilities	(24,412)	(18,289)
Net cash (used in) provided by operating activities	(2,365)	8,289
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(7,532)	(3,468)
Acquisitions, net of cash acquired	(8,320)	(31,619)
Net cash used in investing activities	(15,852)	(35,087)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from issuance of common stock	1,073	1,328
Decrease in restricted cash	56	434
Payments on performance-based contingent payments	(9,454)	(2,043)
Payments on capital lease obligations	(2,210)	(1,687)
Taxes paid on-behalf of employees for withheld shares	(1,307)	(588)
Payments on debt, net	(384)	(6,306)
Borrowings on term loan	20,000	10,000
Borrowings on revolver	61,906	30,000
Payments on revolver	(58,188)	(7,800)
Debt issuance costs	—	(634)
Net cash provided by financing activities	11,492	22,704

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EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	643	(1,034)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(6,082)	(5,128)
CASH AND CASH EQUIVALENTS, beginning of period	21,781	18,128
CASH AND CASH EQUIVALENTS, end of period	\$15,699	\$13,000
SUPPLEMENTAL CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Property and equipment acquired under long-term debt and capital leases	\$3,890	\$3,703

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

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

1. OVERVIEW AND BASIS OF PRESENTATION

PFSweb, Inc. and its direct and indirect 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.; “REV” collectively refers to REV Solutions, Inc. and REVTECH Solutions India Private Limited; “LAL” refers to LiveAreaLabs, Inc.; “Moda” refers to Moda Superbe Limited; “CrossView” refers to CrossView, Inc.; “Conexus” refers to Conexus Limited and “PFSweb” refers to PFSweb, Inc. and its subsidiaries, excluding Supplies Distributors and Retail Connect.

PFSweb Overview

PFSweb is a global provider of omni-channel commerce solutions, including a broad range of technology, infrastructure and professional services, to major brand name companies and others seeking to optimize their supply chain and to enhance their online and traditional business channels and initiatives in the United States, Canada, and Europe. PFSweb’s service offerings include website design, creation and integration, digital agency and marketing, eCommerce technologies, order management, customer care, logistics and fulfillment, financial management and professional consulting.

Supplies Distributors Overview

Supplies Distributors and PFSweb operate under distributor agreements with Ricoh Company Limited and Ricoh USA, Inc., a strategic business unit within the Ricoh Family Group of Companies, (collectively hereafter referred to as “Ricoh”), under which Supplies Distributors acts as a distributor of various Ricoh products. The majority of Supplies Distributors’ revenue is generated by its sale of product purchased from Ricoh.

Supplies Distributors has obtained financing to fund certain working capital requirements for the sale of primarily Ricoh products. Pursuant to the transaction management services agreements between PFSweb and Supplies Distributors, PFSweb 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 Ricoh’s sales force and product demand generation activities for its sale of Ricoh products. Supplies Distributors sells its products in the United States, Canada and Europe.

Supplies Distributors also maintains agreements with certain additional clients where it operates as an agent for the resale of product between the client and the clients’ customer, and records product revenue net of cost of product revenue as a component of service fee revenue. PFSweb also provides various transaction management services to Supplies Distributors under these arrangements.

All of the agreements between PFSweb and Supplies Distributors were made in the context of an affiliate relationship and were negotiated in the overall context of PFSweb’s and Supplies Distributors’ arrangement with the client or vendor. Although management believes 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. All of these transactions are eliminated upon consolidation.

Basis of Presentation

The interim condensed consolidated financial statements as of September 30, 2016, and for the three and nine months ended September 30, 2016 and 2015, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) and are unaudited. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) 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 condensed consolidated financial statements of the Company include all adjustments necessary for a fair presentation of the Company’s financial position as of September 30, 2016, its results of operations for the three and nine months ended September 30, 2016 and 2015 and its cash flows for the nine months ended September 30, 2016 and 2015. Certain prior-year amounts have been reclassified to conform to the current year's presentation. Results of the Company’s operations for interim periods may not be indicative of results for the full fiscal year.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of condensed consolidated financial statements and related disclosures in conformity with U.S. GAAP 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 condensed 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 condensed 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, 2015 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 condensed consolidated financial statements are fairly stated in accordance with U.S. GAAP, and provide a fair presentation of the Company's financial position and results of operations.

Revenue and Cost Recognition

The Company derives revenue primarily from services provided under contractual arrangements with its clients or from the sale of products under its distributor agreements. The following revenue recognition policies define the manner in which the Company accounts for sales transactions.

The Company recognizes revenue when persuasive evidence that a sales arrangement exists, product shipment or delivery has occurred or services are rendered, the sales price or fee is fixed or determinable, and collectability is reasonably assured.

In instances where revenue is derived from sales of third-party vendor services, the Company records revenue on a gross basis when the Company is a principal to the transaction and net of costs when the Company is acting as an agent between the customer or client and the vendor. The Company considers several factors to determine whether it is a principal or an agent, most notably whether the Company is the primary obligor to the vendor or customer, has established its own pricing and has inventory and credit risks, if applicable.

Service Fee Revenue Activity

The Company's service fee revenue primarily relates to its distribution services, order management/customer care services, professional digital agency and technology services. The Company typically charges its service fee revenue on either a cost-plus basis, a percent of shipped revenue basis, on a time and materials, project or retainer basis for professional services, or a per transaction basis, such as a per item basis for fulfillment services or a per labor hour basis for web-enabled customer contact center services. Additional fees are billed for other services.

The Company evaluates its contractual arrangements to determine whether or not they include multiple service elements. Revenue recognition is determined for the separate service elements of the contract in accordance with the requirements of Accounting Standards Codification ("ASC") 605, "Revenue Recognition." A deliverable constitutes a separate unit of accounting when it has standalone value and there are no return rights or other contingencies present for the delivered elements. The Company allocates revenue to each element based on estimated selling price. Each of the Company's client contracts, and the related services, is unique, with individual needs and criteria customized for each client. Each client engagement is scoped and priced separately and as such the Company is not able to establish vendor specific objective evidence of fair value for its services, nor is third-party evidence available to establish stand-alone selling prices. Accordingly the Company uses management's best estimate of selling price for the

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

deliverables. The Company establishes its estimates considering internal factors such as margin objectives, pricing practices and controls as well as market conditions such as competitor pricing strategies.

Distribution services relate primarily to inventory management, product receiving, warehousing and fulfillment (i.e., picking, packing and shipping) and facilities and operations management. Service fee revenue for these activities is recognized as earned, which is either (i) on a per transaction basis or (ii) at the time of product fulfillment, which occurs at the completion of the distribution services.

Order management/customer care services relate primarily to taking customer orders for the Company's clients' products. These services also entail addressing customer questions related to orders, as well as cross-selling/up-selling activities. Service fee revenue for this activity is recognized as the services are rendered. Fees charged to the client are on a per transaction basis based on either (i) a pre-determined fee per order or fee per telephone minutes incurred, (ii) a per dedicated agent fee, or (iii) are included in the product fulfillment service fees that are recognized on product shipment.

Professional consulting and technology service revenues primarily relate to design, implementation, service and support of eCommerce platforms, website design and solutions and quality control for the Company's clients. Additionally, the Company provides digital agency services that enable client marketing programs to attract new customers, convert buyers and increase website value. These fees are typically charged on either a per labor hour basis, or transaction basis, a dedicated resource model, a fixed price arrangement, or a percent of merchandise shipped basis. Service fee revenue for this activity is generally recognized as the services are rendered.

The Company performs front-end set-up and integration services to support client eCommerce platforms and websites. When the Company determines these front-end set-up and integration services do not meet the criteria for recognition as a separate unit of accounting, the Company defers the start-up fees received and the related costs, and recognizes them over the expected performance period. When the Company determines these front-end set-up and integration services do meet the criteria for recognition as a separate unit of accounting, for time and material arrangements, the Company recognizes revenue as services are rendered and costs as they are incurred. For fixed-price arrangements, the Company uses the completed contract method to recognize revenues and costs if reasonable and reliable cost estimates for a project cannot be made. If reasonable and reliable costs estimates for a project can be made, the Company recognizes revenue over the expected performance period on a proportional performance basis, as determined by the relationship of actual costs incurred compared to the estimated total contract costs. At the time a loss in a contract is expected, the entire amount of the estimated loss is accrued.

The Company's billings for reimbursement of out-of-pocket expenses, including travel and certain third-party vendor expenses such as shipping and handling costs and telecommunication charges, are included in pass-through revenue. The related reimbursable costs are reflected as cost of pass-through revenue.

The Company's cost of service fee revenue, representing the cost to provide the services described above, is recognized as incurred. Cost of service fee revenue also includes certain costs associated with technology collaboration and ongoing technology support that include maintenance, web hosting and other ongoing programming activities. These activities are primarily performed to support the distribution and order management/customer care services and are recognized as incurred.

Product Revenue Activity

Depending on the terms of the customer arrangement, Supplies Distributors recognizes product revenue and product cost either upon the shipment of product to customers or when the customer receives the product. Supplies Distributors permits its customers to return product for credit against other purchases, which include returns for defective products (that Supplies Distributors then returns to the manufacturer) and incorrect shipments. Supplies Distributors provides a reserve for estimated returns and allowances and offers terms to its customers that it believes are standard for its industry.

Freight costs billed to customers are reflected as components of product revenue. Freight costs incurred are recorded as a component of cost of product revenue.

Under its distributor agreements, Supplies Distributors bills Ricoh for reimbursements of certain expenses, including: pass-through customer marketing programs, including rebates and co-op funds; certain freight costs; direct costs incurred in passing on any price decreases offered by Ricoh to Supplies Distributors or its customers 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. Supplies Distributors

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

records these reimbursable amounts as they are incurred as other receivables in the condensed consolidated balance sheet with a corresponding reduction in either inventory or cost of product revenue. Supplies Distributors also records pass-through customer marketing programs as a reduction of both product revenue and cost of product revenue.

Accounts Receivable

The Company recognizes revenue and records trade accounts receivable, pursuant to the methods described above, when collectability is reasonably assured. Collectability is evaluated in the aggregate and on an individual customer or client basis taking into consideration payment due date, historical payment trends, current financial position, results of independent credit evaluations and payment terms. Related reserves are determined by either using percentages applied to certain aged receivable categories based on historical results, reevaluated and adjusted as additional information is received, or a specific identification method. After all attempts to collect a receivable have failed, the receivable is written off against the allowance for doubtful accounts.

Deferred Revenues and Deferred Costs

The Company primarily performs its services under multiple-year contracts, certain of which include early termination provisions, and clients are obligated to pay for services performed. In conjunction with these long-term contracts, the Company sometimes receives start-up fees to cover its implementation costs, including certain technology infrastructure and development costs. When the Company determines that these start-up and integration activities do not meet the criteria for recognition as a separate unit of accounting, the Company defers the start-up fees received, and the related costs, and recognizes them over the expected performance period. The amortization of deferred revenue is included as a component of service fee revenue. The amortization of deferred implementation costs is included as a cost of service fee revenue. To the extent implementation costs for non-technology infrastructure and development exceed the corresponding fees received, the excess costs are expensed as incurred.

Advances to Affiliates

Priority Fulfillment Services, Inc. ("PFS") a wholly-owned subsidiary of PFSweb, Inc. has made advances to Supplies Distributors that are evidenced by a Subordinated Demand Note (the "Subordinated Note"). Under the terms of certain of Supplies Distributors' debt facilities, the outstanding balance of the Subordinated Note cannot be decreased to less than \$2.5 million without prior approval of certain of Supplies Distributors' lenders. As of September 30, 2016 and December 31, 2015, the outstanding balance of the Subordinated Note was \$2.5 million. The Subordinated Note is eliminated in the Company's condensed consolidated financial statements.

Concentration of Business and Credit Risk

One service fee client relationship represented approximately 10% and 13% of the Company's consolidated total revenues during the nine months ended September 30, 2016 and 2015, respectively. No customer or service fee clients exceeded 10% of consolidated accounts receivable as of September 30, 2016 or 2015.

A summary of the nonaffiliated customer and client concentrations as a percentage of product revenue and service fee revenue, respectively, is as follows:

	Nine Months Ended September 30, 2016 2015	
Service Fee Revenue (as a percentage of total Service Fee Revenue):		
Client 1	10 %	13 %
Product Revenue (as a percentage of total Product Revenue):		
Customer 1	13 %	15 %
Customer 2	15 %	14 %

The Company currently anticipates that its product revenue from the customers identified above will decline during the next twelve months.

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.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

The Company has multiple arrangements with International Business Machines Corporation (“IBM”) and Ricoh. These arrangements include Supplies Distributors’ distributor agreements and certain of Supplies Distributors’ working capital financing agreements. The majority of Supplies Distributors’ revenue is generated by its sale of product purchased from Ricoh. Supplies Distributors also relies upon Ricoh’s 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 Ricoh business affiliates.

As a result of certain operational restructuring of its business, Ricoh has implemented, and will continue to implement, certain changes in the sale and distribution of Ricoh products. The changes have resulted, and are expected to continue to result, in reduced revenues and profitability for Supplies Distributors.

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 Ricoh 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 Ricoh terminate the distributor agreements, the agreements provide for the parties to mutually agree on a plan of disposition of Supplies Distributors’ then existing inventory.

Operating Leases

The Company leases certain real estate for its warehouse, call center, sales, professional services and corporate operations, as well as certain equipment, under non-cancelable operating leases that expire at various dates through 2026. Management expects that, in the normal course of business, leases that expire will be renewed or replaced by other similar leases. The Company recognizes escalating lease payments on a straight-line basis over the term of each respective lease with the difference between cash payments and rent expense recognized being recorded as deferred rent in the accompanying condensed consolidated balance sheets.

Property and Equipment

The Company’s property and equipment held under capital leases totaled approximately \$5.4 million and \$5.5 million, net of accumulated amortization of approximately \$5.2 million and \$4.6 million, at September 30, 2016 and December 31, 2015, respectively. Depreciation and amortization expense related to capital leases during three months ended September 30, 2016 and 2015 was \$.08 million and \$.07 million, respectively. Depreciation and amortization expense related to capital leases during nine months ended September 30, 2016 and 2015 was \$2.1 million and \$1.7 million, respectively.

Income Taxes

The Company records a tax provision primarily associated with state income taxes and its foreign operations. The Company has recorded a valuation allowance for the majority of its domestic net deferred tax assets, which are primarily related to its net operating loss carryforwards, and for certain foreign deferred tax assets.

Cash Paid for Interest and Taxes

The Company made payments for interest of approximately \$0.5 million and \$0.4 million in the three months ended September 30, 2016 and 2015, respectively, and \$1.1 million and \$0.6 million in the nine month periods ended September 30, 2016 and 2015, respectively. Income taxes of approximately \$0.1 million were paid by the Company in both the three months ended September 30, 2016 and 2015, and \$0.7 million was paid by the Company during both the nine month periods ended September 30, 2016 and 2015.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

Impact of Recently Issued Accounting Standards

In March 2016, the Financial Accounting Standards Board (the “FASB”) issued Accounting Standards Update (“ASU”) 2016-09, “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.” The amendment in this ASU affects all organizations that issue share-based payment awards to employees and is intended to simplify several aspects of the accounting for these awards, including income tax consequences, classification of awards as either equity or liabilities, classification on the statement of cash flows, and allowing an accounting policy election to account for forfeitures as they occur. As permitted by ASU 2016-09, the Company elected to early adopt ASU 2016-09 in the quarter ended June 30, 2016 with an effective date of January 1, 2016. As a result of the adoption, the Company recognized previously unrecognized excess tax benefits of \$1.9 million, which was offset by a valuation allowance in the same amount as the Company does not believe, on a more-likely-than-not basis, the net operating losses will be realized. The adoption of ASU 2016-09 resulted in a cumulative adjustment to equity, subject to a full valuation allowance, as of January 1, 2016.

The Company has not yet adopted and is currently assessing the potential effect of the following pronouncements on its condensed consolidated financial statements and related disclosures:

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606) (“ASU 2014-09”), which outlines a single, comprehensive model for entities to use in accounting for revenue arising from contracts with customers. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration that is expected to be received for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, it is possible more judgment and estimates may be required within the revenue recognition process than required under existing U.S. GAAP, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. ASU 2014-09 is effective for the fiscal year beginning January 1, 2018, with early adoption permitted for fiscal years beginning January 1, 2017. The FASB has also issued the following standards which clarify ASU 2014-09 and have the same effective date as the original standard:

- ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net);
- ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing; and
- ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients.

In February 2016, the FASB issued ASU 2016-02, “Leases”. The new standard establishes a right-of-use (“ROU”) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments - a consensus of the Emerging Issues Task Force (“ASU 2016-15”). The new guidance is

intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. Certain issues addressed in this guidance include - Debt payments or debt extinguishment costs, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, distributions received from equity method investments and beneficial interests in securitization transactions. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

3. ACQUISITIONS

Acquisitions have been recorded using the purchase method of accounting for business combinations.

Acquisition Related Expenses

The acquisitions discussed below are expected to enhance the Company's overall service offering to its existing clients and customers as well as support anticipated growth opportunities. For the three months ended September 30, 2016 and 2015, acquisition related expenses were \$0.1 million and \$1.7 million, respectively, and for the nine months ended September 30, 2016 and 2015, acquisition related expenses were \$1.7 million and \$3.0 million, respectively, and recognized in selling, general and administrative expenses in the condensed consolidated statements of operations.

2016 Acquisition

Acquisition of Conexus

On June 8, 2016, PFSweb, Inc. acquired the outstanding capital stock of Conexus, an eCommerce system integrator that provides strategic consulting, system integration, and managed services for leading businesses and technology companies. Conexus maintains primary operations in Basingstoke, Hampshire (U.K.). The purchase price for the shares consists of (i) an initial cash payment of £5,855,000 (approximately \$8.5 million), subject to a post-closing adjustment based upon a May 31, 2016 balance sheet analysis, and (ii) up to an aggregate maximum of £1,445,000 (approximately \$1.9 million at September 30, 2016), subject to Conexus achieving certain operational and financial targets during the post-closing period ending December 31, 2016 (the "Earn-out Payments"), subject to possible offsets for indemnification and other claims arising under the purchase agreement. Up to 40% (but not to exceed £450,000) (approximately \$0.6 million at September 30, 2016) of the Earn-out Payments may be paid by the issuance of restricted shares of PFSweb common stock, based on its then current market value at the time of issuance. As of September 30, 2016, as a result of updated Conexus financial projections for the 2016 earn-out period, the Company has not recorded a liability applicable to the estimated Earn-out Payments and the estimated performance-based liability was reduced from \$0.6 million as of June 30, 2016 to \$0 as of September 30, 2016.

The results of operations of Conexus have been included in the Company's condensed consolidated financial statements since the date of acquisition which, for the three and nine months ended September 30, 2016, includes \$1.7 million and \$2.2 million, respectively, of service fee revenue and approximately \$41,000 and \$0.4 million, respectively, of net loss. The net loss for Conexus for the nine months ended September 30, 2016 included approximately \$0.5 million of acquisition related expenses. Additional acquisition related expenses applicable to the Conexus acquisition of approximately \$0.1 million and \$1.1 million were also incurred by the Company during the three and nine months ended September 30, 2016, respectively. The Company determined fair value using a combination of the discounted cash flow, market multiple and market capitalization valuation methods. The Company is in the process of finalizing the purchase price allocation and, accordingly, the following preliminary allocation of the purchase price is subject to adjustment.

The following table summarizes the preliminary estimated fair value of the tangible and intangible assets acquired and liabilities assumed (in thousands):

Cash	\$156
Accounts receivable, net	1,451
Other receivables	909
Property and equipment	200
Other assets	82
Intangible assets	2,181
Total assets acquired	4,979
Total liabilities assumed	2,254
Net assets acquired	2,725
Goodwill	6,055
Total purchase price	\$8,780

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

Purchase price for Conexus is as follows (in thousands):

Aggregate cash payments	\$	8,476
Performance-based contingent payments (based on estimated fair value at acquisition date)		553
Estimated post-closing balance sheet reconciliation adjustment		(249)
Total purchase price	\$	8,780

The excess of the purchase price over the fair value of the net identifiable assets acquired and liabilities assumed was allocated to goodwill. Total goodwill of \$6.1 million, none of which is deductible for tax purposes, is not being amortized but is subject to an annual impairment test using a fair-value-based approach.

The Company is amortizing the identifiable intangible assets acquired using a pattern in which the economic benefit of the assets are expected to be realized by the Company over their estimated remaining useful lives. There are no residual values for any of the intangible assets subject to amortization acquired during the Conexus acquisition. Estimated definite lived intangible assets acquired in the Conexus acquisition consist of (in thousands):

	Fair Value at Acquisition	September 30, 2016 Accumulated Amortization	Net Carrying Value	Estimated Useful Life from Acquisition
Developed technology	\$ 727	\$(73)	\$ 654	2.5 years
Customer relationships	1,454	(256)	1,198	4.5 years
Total definite lived intangible assets	\$ 2,181	\$(329)	\$ 1,852	

2015 Acquisitions

Acquisition of Moda

On June 11, 2015, PFSweb, Inc. acquired the outstanding capital stock of Moda, an eCommerce system integrator and consultancy that provides unique digital experiences for fashion brands and retailers. Moda maintains primary operations in London. Consideration paid for the shares included an initial £650,000 (approximately \$1.0 million) cash payment and 16,116 unregistered shares of Company stock (approximately \$0.2 million in value as of the

acquisition date). The purchase agreement provides for future earn-out payments (“Moda Earn-out Payments”) payable in 2017 based on Moda’s achievement of certain 2016 financial targets, with no guaranteed minimum and an aggregate maximum of £600,000 (approximately \$0.8 million), subject to possible offsets for indemnification and other claims arising under the purchase agreement. As of September 30, 2016, as a result of updated 2016 Moda financial projections, the Company has not recorded a liability applicable to the estimated Moda Earn-out Payments and the estimated performance-based contingent liability for the Moda Earn-out Payments was reduced from \$0.3 million as of December 31, 2015 to \$0 as of September 30, 2016 .

The results of operations of Moda have been included in the Company's condensed consolidated financial statements since the date of acquisition.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

The Company determines fair value using a combination of the discounted cash flow, market multiple and market capitalization valuation methods. The following table summarizes the fair value of the tangible and intangible assets acquired and liabilities assumed (in thousands):

Cash and cash equivalents	\$ 126
Accounts receivable	335
Property and equipment	27
Identifiable intangibles	340
Other assets	23
Total assets acquired	851
Total liabilities assumed	658
Net assets acquired	193
Goodwill	1,287
Total purchase price	\$ 1,480

Purchase price for Moda is as follows (in thousands, except share data and stock price):

Number of shares of common stock issued	16,116
Multiplied by PFSweb Inc.'s stock price	\$ 14.60
Share consideration	\$ 235
Aggregate cash payments	1,005
Performance-based contingent payments (based on estimated fair value at acquisition date)	240
Total purchase price	\$ 1,480

The excess of the purchase price over the fair value of the net identifiable assets acquired and liabilities assumed was allocated to goodwill. Total goodwill of \$1.3 million, none of which is deductible for tax purposes, is not being amortized but is subject to an annual impairment test using a fair-value-based approach.

The Company is amortizing the identifiable intangible assets acquired using a pattern in which the economic benefit of the assets are expected to be realized by the Company over their estimated remaining useful lives. There are no residual values for any of the intangible assets subject to amortization acquired during the Moda acquisition. Definite lived intangible assets acquired in the Moda acquisition consist of (in thousands):

	September 30, 2016	December 31, 2015	Estimated
Fair Value at Acquisition	Net Accumulated Amortization	Net Accumulated Amortization	Useful Life from Acquisition

Customer relationships	\$ 309	\$ (245)	\$ 64	\$(141)	\$ 168	1.6 years
Non-compete agreements	31	(28)	3	(12)	19	2.5 years
Total definite lived intangible assets	\$ 340	\$ (273)	\$ 67	\$(153)	\$ 187	

Acquisition of CrossView

On August 5, 2015, PFSweb, Inc. acquired substantially all of the assets, and assumed substantially all of the liabilities, in each case, other than certain specified assets and liabilities, of CrossView, an ecommerce systems integrator and provider of a wide range of ecommerce services in the U.S. and Canada.

Consideration paid by the Company included an initial cash payment of \$30.7 million and 553,223 unregistered shares of Company common stock (approximately \$6.3 million in value as of the acquisition date). The initial cash payment was subject to adjustment based upon a post-closing balance sheet reconciliation. In addition, the purchase agreement provides for future earn-out payments (“CrossView Earn-out Payments”) payable in 2016, 2017 and 2018 based on the achievement of certain 2015, 2016 and 2017 financial targets. The CrossView Earn-out Payments have no guaranteed minimum and an aggregate maximum of \$18.0 million and are subject to possible offsets for indemnification and other claims. In the quarter ended June 30, 2016, the Company paid an aggregate of \$7.9 million in settlement of the 2015 CrossView Earn-out Payments, of which, \$1.6 million was paid by the issuance of

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

restricted shares of Company stock. The Company will pay 15% of any 2016 and 2017 earn-outs payments in restricted shares of Company common stock, based on its current market value at the time of issuance. As of September 30, 2016, the Company has recorded a total liability of \$0.4 million applicable to the remaining projected CrossView Earn-out Payments, which is included in other liabilities in the condensed consolidated balance sheets. This estimated performance-based liability was reduced from \$10.2 million as of December 31, 2015 to \$0.4 million as of September 30, 2016 following \$7.9 million of payments during the nine months ended September 30, 2016 and as a result of updated CrossView financial projections for the 2016 and 2017 earn-out periods.

The results of operations of CrossView have been included in the Company's condensed consolidated financial statements since the date of acquisition.

The Company determined fair value using a combination of the discounted cash flow, market multiple and market capitalization valuation methods. The following table summarizes the fair value of the tangible and intangible assets acquired and liabilities assumed (in thousands):

Accounts receivable	\$7,550
Property and equipment	441
Other assets	149
Identifiable intangibles	9,050
Total assets acquired	17,190
Total liabilities assumed	2,556
Net assets acquired	14,634
Goodwill	30,221
Total purchase price	\$44,855

Purchase price for CrossView is as follows (in thousands, except share data and stock price):

Number of shares of common stock issued		553,223
Multiplied by PFSweb Inc.'s stock price	\$	11.40
Share consideration	\$	6,307
Aggregate cash payments		30,740
Performance-based contingent payments (based on estimated fair value at acquisition date)		9,195
		(1,387)

Post-closing balance sheet
reconciliation adjustment

Total purchase price	\$	44,855
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The excess of the purchase price over the fair value of the net identifiable assets acquired and liabilities assumed was allocated to goodwill. Total goodwill of \$30.2 million, which, given the structure of the acquisition, is expected to be deductible for tax purposes over 15 years.

The Company is amortizing the identifiable intangible assets acquired using a pattern in which the economic benefit of the assets are expected to be realized by the Company over their estimated remaining useful lives. There are no residual values for any of the intangible assets subject to amortization acquired during the CrossView acquisition. Definite lived intangible assets acquired in the CrossView acquisition consist of (in thousands):

		September 30, 2016		December 31, 2015		Estimated Useful Life from Acquisition
	Fair Value at Acquisition	Accumula- Amortization	Net Carrying Value	Accumula- Amortization	Net Carrying Value	
Trade names	\$ 1,100	\$(513)	\$ 587	\$(183)	\$ 917	2.5 years
Non-compete agreements	300	(117)	183	(42)	258	3 years
Customer relationships	6,800	(2,762)	4,038	(1,394)	5,406	9 years
Developed technology	850	(393)	457	(140)	710	2.5-3 years
Total definite lived intangible assets	\$ 9,050	\$(3,785)	\$ 5,265	\$(1,759)	\$ 7,291	

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PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

Performance-Based Contingent Payment

The following table presents the change in the acquisition related performance-based contingent payments for the periods presented:

	2016	2015
As of January 1,	\$14,157	\$5,392
CrossView earn-out payment in common stock and cash	(7,942)	—
LAL earn-out payment in common stock and cash	(2,000)	(950)
REV earn-out payment in common stock and cash	(1,750)	(1,393)
Value recorded at acquisition - CrossView	—	12,723
Value recorded at acquisition - Conexus	553	—
Value recorded at acquisition - Moda	—	480
Change in balance due	(2,638)	403
As of September 30,	\$380	\$16,655

Pro Forma Information

The following table presents selected pro forma information, for comparative purposes, assuming the acquisitions of Conexus and CrossView had occurred on January 1, 2015 (in thousands, except per share amounts):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2016	2015	2016	2015
Total revenues	\$79,910	\$73,425	\$235,194	\$219,727
Net loss	(1,039)	(2,043)	(4,352)	(8,163)
Basic and diluted net loss per share	(0.06)	0.11	(0.23)	(0.47)

The unaudited pro forma total revenues and pro forma net loss are not necessarily indicative of the consolidated results of operations for future periods or the results of operations that would have been realized had the Company consolidated Conexus and CrossView during the periods noted. Moda did not meet the significance test requirements and thus is not included in the pro forma presentation above.

4. GOODWILL AND IDENTIFIABLE INTANGIBLES, NET

Goodwill acquired through acquisitions is recognized as part of the PFSweb segment and was \$45.9 million and \$39.8 million as of September 30, 2016 and December 31, 2015, respectively. As discussed in note 3, the Company acquired Conexus in June of 2016 and recognized goodwill of \$6.1 million. The Company determined fair value using a combination of the discounted cash flow, market multiple and market capitalization valuation methods.

The following table presents the gross carrying value and accumulated amortization for identifiable intangibles:

	September 30, 2016			December 31, 2015			Estimated Useful Life from Acquisition
	Fair Value at Acquisition	Accumulated Amortization	Net Carrying Value	Fair Value at Acquisition	Accumulated Amortization	Net Carrying Value	
Trade names	\$1,250	\$ (719)	\$ 531	\$1,250	\$ (266)	\$ 984	2.25 - 2.5 years
Non-compete agreements	575	(296)	279	575	(159)	416	1- 3.5 years
Leasehold	45	(38)	7	45	(24)	21	2.5 years
Customer relationships	10,433	(4,367)	6,066	8,979	(2,378)	6,601	1.6 - 9 years
Developed technology	1,577	(393)	1,184	850	(140)	710	2.5-3 years
Other intangibles	492	(434)	58	468	(390)	78	9 years
Total definite lived intangible assets	\$14,372	\$ (6,247)	\$ 8,125	\$12,167	\$ (3,357)	\$ 8,810	

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Definite Lived Intangible Asset Amortization

For the three months ended September 30, 2016 and 2015, amortization expense related to acquired definite lived intangible assets was \$1.2 million and \$1.0 million, respectively, and for the nine months ended September 30, 2016 and 2015, amortization expense was \$2.9 million and \$1.5 million, respectively, and recognized in selling, general and administrative expenses in the condensed consolidated statements of operations. The estimated amortization expense for each of the next five years is as follows (in thousands):

Remaining 2016	\$ 1,186
2017	3,220
2018	1,780
2019	748
2020	526
2021 and thereafter	665

5. NET LOSS PER COMMON SHARE

Basic and diluted net loss per common share are computed by dividing net loss by the weighted-average number of common shares outstanding for the reporting period.

The following equity awards have been excluded from the calculation of diluted net loss per share as their effect would be anti-dilutive as of September 30, 2016:

(shares in thousands)	As of September 30,	
	2016	2015
Stock options	1,209	1,371
Performance shares	273	545
Deferred stock units	104	65
Total anti-dilutive stock options, performance shares and deferred stock units	1,586	1,981

6. STOCK AND STOCK OPTIONS

Total stock-based compensation expense was \$0.3 million and \$1.5 million for the three months ended and \$1.4 million and \$3.4 million for the nine months ended, September 30, 2016 and 2015, respectively, and were included as a component of selling, general and administrative expenses in the condensed consolidated statements of operations.

On March 23, 2015, pursuant to the Company's Employee Stock and Incentive Plan, as amended and restated ("the Plan"), the Company issued approximately 12,000 Other Stock-Based Awards and approximately 38,000 Restricted Stock Unit Awards (as such terms are defined in the Plan) to certain of the Company's executive officers and senior management. The Restricted Stock Unit Awards are subject to three year vesting beginning in 2015 based on continued employment. The Company also issued additional Restricted Stock Units and Performance-Based Share Awards (as such terms are defined in the Plan) to the Company's executives and senior management. Under the terms of these additional 2015 awards, the determination of the number of Restricted Stock Units and Performance Shares that each such individual received was subject to, and calculated by reference to, the achievement by the Company of a performance goal measured by a range of targeted financial performance, as defined, for 2015, as well as, for certain of the Restricted Stock Units, individual performance goals, as defined. Based on the Company's 2015 results, the Company issued an aggregate of approximately 283,000 Performance Shares and 84,000 Restricted Stock Units for 2015. The Performance Shares are subject to annual vesting based upon continued employment and either the achievement of a defined annual financial target or for certain of the Performance Shares, the comparative performance (on an annual and cumulative basis) of the Company's common stock on NASDAQ compared to the Russell Micro Cap Index.

During 2016, the Company issued additional Restricted Stock Units and Performance-Based Share Awards (as such terms are defined in the Plan) to certain of the Company's executives and senior management. Under the terms of these 2016 awards, the number of restricted stock units and performance shares that each such individual may receive is subject to, and calculated by reference to, the achievement by the Company of a performance goal measured by a range of targeted financial performance, as defined, for 2016, as well as, for certain of the restricted stock units, individual performance goals, as defined. Assuming achievement

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

of the highest financial and individual performance goal, the aggregate maximum number of restricted stock units is approximately 91,000 and the aggregate maximum number of performance shares is approximately 282,000, which performance shares are subject to annual vesting based upon continued employment and, for certain of the performance shares, the achievement of a defined annual financial target or the comparative performance (on an annual and cumulative basis) of the Company's common stock on NASDAQ compared to the Russell Micro Cap Index.

7. VENDOR FINANCING

Supplies Distributors has a short-term credit facility with IBM Credit LLC to finance its distribution of Ricoh products in the United States, providing financing for eligible Ricoh inventory and certain receivables up to \$13.0 million. The agreement has no stated maturity date and provides either party the ability to exit the facility following a 90-day notice. 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, which were \$8.3 million and \$8.2 million as of September 30, 2016 and December 31, 2015, respectively, as accounts payable in the condensed consolidated balance sheets. As of September 30, 2016, Supplies Distributors had no available credit under this facility. The credit facility 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 entities directly or indirectly owned by PFSweb, Inc.), provide guarantees, make investments and loans, pledge assets, make changes to capital stock ownership structure and pay dividends. The credit facility also contains 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 is secured by certain of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFS is required to maintain a minimum Subordinated Note receivable balance from Supplies Distributors of \$2.5 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at prime rate plus 0.5% (4.00% as of September 30, 2016). The facility also includes a monthly service fee. As of September 30, 2016, the Company was in compliance with all financial covenants.

8. DEBT AND CAPITAL LEASE OBLIGATIONS

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

	September 30, 2016	December 31, 2015
U.S. Credit Agreement		

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Revolver	\$ 23,000	\$ 19,283
Term loan	30,000	10,000
Equipment loan	1,824	—
Debt issuance costs	(562)	(671)
Master lease agreements	6,042	6,644
Other	117	135
Total	60,421	35,391
Less current portion of long-term debt	5,672	3,153
Long-term debt, less current portion	\$ 54,749	\$ 32,238

U.S. Credit Agreement

In August 2015, PFSweb, Inc. and its U.S. subsidiaries entered into a credit agreement (“Credit Agreement”) with Regions Bank, as agent for itself and one or more future lenders including Bank of America N.A. and HSBC Bank USA, National Association (“the Lenders”). Under the Credit Agreement, and subject to the terms set forth therein, the Lenders have agreed to provide PFS with a revolving loan facility for up to \$32.5 million and a term loan facility for up to \$30 million through August 5, 2020. Subject to the terms of the Credit Agreement, PFS has the ability to increase the total loan facilities to \$75 million. Availability under the revolving loan facility may not exceed a borrowing base of eligible accounts receivable (as defined). As of September 30, 2016, the Company had \$9.5 million available credit under the revolving loan facility and no remaining available credit under the term loan facility. Advances under the revolving loan portion of the Credit Agreement are due and payable on August 5, 2020. Term loan advances amortize during the five year term of the Credit Agreement based upon scheduled percentage payments with the then remaining outstanding balance (potentially up to 65% of the amount borrowed) due on August 5, 2020. Borrowings under the Credit Agreement accrue interest at a variable rate based on prime rate or Libor, plus an applicable margin. As of September 30, 2016, the weighted average interest rates on the revolving loan facility and the term loan facility were 3.28% and 2.90%, respectively. In connection with

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

the Credit Agreement, the Company paid \$0.7 million of fees, which are being amortized through the life of the Credit Agreement and are reflected as a net reduction in debt. The Credit Agreement is secured by a lien on substantially all of the assets of Company and its U.S. subsidiaries and a pledge of 65% of the shares of certain of the Company's foreign subsidiaries. The Credit Agreement contains cross default provisions, various restrictions upon the Company's ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to subsidiaries, affiliates and related parties, make capital expenditures, make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants, as defined, of a minimum consolidated fixed charge ratio and a maximum consolidated leverage ratio. In June 2016, PFSweb also entered into a Master Agreement with Regions Bank to provide equipment loans financing for certain capital expenditures. As of September 30, 2016, there was approximately \$1.8 million outstanding under the Equipment Loans Master Agreement.

Debt Covenants

To the extent the Company or any of its subsidiaries fail to comply with its covenants applicable to its debt or vendor financing obligations, including the periodic financial covenant requirements, such as profitability and cash flow, and required level of shareholders' equity or net worth, (as defined), the Company would be required to obtain a waiver from the lender or the lender would be entitled to accelerate the repayment of any outstanding credit facility obligations, and exercise all other rights and remedies, including sale of collateral and enforcement of payment under the Company parent guarantee. Any acceleration of the repayment of the credit facilities may 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 and for the nine months ended September 30, 2016, the Company was in compliance with all debt covenants.

Master Lease Agreements

The Company has various agreements that provide for leasing or financing transactions of equipment and other assets 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, which generally have terms of three to five years, are generally secured by the related equipment, and in certain cases, by a Company parent guarantee.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

9. SEGMENT INFORMATION

The Company is currently organized into two primary operating segments, which generally align with its corporate organization structure. In the first segment, PFSweb is a global provider of various infrastructure, technology, and digital agency 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 recognizes product revenue when it operates as a principal in the arrangement and service fee revenue when it operates as an agent.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Revenues (in thousands):				
PFSweb	\$ 67,768	\$ 56,897	\$ 194,239	\$ 153,040
Business and Retail Connect	15,351	17,975	48,425	55,870
Eliminations	(3,209)	(3,689)	(10,476)	(10,705)
	\$ 79,910	\$ 71,183	\$ 232,188	\$ 198,205
Income (loss) from operations (in thousands):				
PFSweb	\$(447)	\$(2,757)	\$(2,516)	\$(6,288)
Business and Retail Connect	441	31	1,323	948
	\$(6)	\$(2,726)	\$(1,193)	\$(5,340)
Depreciation and amortization (in thousands):				
PFSweb	\$ 3,797	\$ 4,086	\$ 11,188	\$ 10,607
Business and Retail Connect	6	15	18	38
	\$ 3,803	\$ 4,101	\$ 11,206	\$ 10,645
Capital expenditures (in thousands):				
PFSweb	\$ 1,049	\$ 1,522	\$ 7,532	\$ 3,468
Business and Retail Connect	—	—	—	—
	\$ 1,049	\$ 1,522	\$ 7,532	\$ 3,468

	September 30,	December 31,
	2016	2015
Assets (in thousands):		
PFSweb	\$ 155,888	\$ 151,064
Business and Retail Connect	37,501	50,682
Eliminations	(10,245)	(10,456)
	\$ 183,144	\$ 191,290

10. RELATED PARTY TRANSACTIONS

In September 2014, the Company purchased all of the stock of REV Solutions, Inc. and REVTech Solutions India Private Limited from Mr. Steven Stephan, an officer of the Company until September 30 2016, and other shareholders in a transaction which, in addition to a closing payment, provided for earn-out payments based on the achievement of certain metrics for each of calendar years 2014 and 2015. Since January 1, 2015, the Company paid Mr. Stephan an aggregate of \$2.4 million and issued 38,574 shares of common stock as the final purchase price earn-out payments associated with such transaction.

11. COMMITMENTS AND CONTINGENCIES

The Company received municipal tax abatements in certain locations. In prior years, the Company received notice from a municipality that it did not satisfy certain criteria necessary to maintain the abatements and 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

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

payments has not been finalized. As of September 30, 2016, the Company believes it has adequately accrued for the expected assessment.

In connection with a client project, the Company has provided a \$1.3 million performance bond which may be drawn upon in the event of a default by the Company of its obligations under the project, or, in the absence of a default, upon successful completion of the project, the bond will be returned.

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. The Company is generally required to indemnify its service fee clients against any third party claims asserted against such clients alleging infringement by the Company of the patents, trademarks and other intellectual property rights of third parties.

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 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 similar expressions, we 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, 2015, 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, product sales and technology and agency projects and support of our clients;
- our reliance on our clients' projections or transaction volume or product sales;
- our dependence upon our agreements with International Business Machines Corporation ("IBM") and Ricoh Company Limited and Ricoh USA, Inc., a strategic business unit within the Ricoh Family Group of Companies, (collectively hereafter referred to as "Ricoh");
- 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 client and customer 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 to 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;
- our reliance on third-party providers and other 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 upon key personnel;
- our ability to retain seasonal and temporary workers;
- 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;
- our relationship with, and our guarantees of, certain of the liabilities and indebtedness of our subsidiaries; and
- taxation on the sale of our products and provision of our services.

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 will actually 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.

Key Transactions and Events

During 2015, we were impacted by the following key transactions and events that also affect comparability of our results to prior periods and are discussed further in our Form 10-K for the year ended December 31, 2015:

- Acquired the outstanding capital stock of Moda Superbe Limited (“Moda”) on June 11, 2015. The results of operations of Moda have been included in our condensed consolidated financial statements since the acquisition date.

- Completed an asset purchase agreement with CrossView, Inc. (“CrossView”) and its shareholders on August 5, 2015. The results of operations of CrossView have been included in our condensed consolidated financial statements since the acquisition date.

During 2016, we acquired the outstanding capital stock of Conexus Limited (“Conexus”) on June 8, 2016. The results of operations of Conexus have been included in our condensed consolidated financial statements since the acquisition date.

Overview

We are a global provider of omni-channel commerce solutions. Comprised of a broad range of technology, critical infrastructure and professional services, we provide our clients with best-of-breed capabilities offered as a complete end-to-end solution or on an à la carte basis. We provide these solutions and services to major brand name companies and others seeking to optimize their supply chain and to enhance their online and traditional business channels and initiatives. We derive our revenues from providing a broad range of services using three different seller services financial models: 1) the Service Fee model, 2) the Agent (or Flash) model and 3) the Retail model.

We refer to the standard PFSweb seller services financial model as the Service Fee model. In this model, our clients own the inventory and are the merchants of record and engage us to provide various infrastructure, technology and digital agency services in support of their business operations. We derive our service fee revenues from a broad range of service offerings that include digital agency and marketing, eCommerce technologies, system integration, 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 ecommerce needs to a single source and to focus on their core competencies though clients are also able to select individual or groupings of our various service offerings on an à la carte basis. We currently provide services to clients that operate in a range of vertical markets, including technology manufacturing, computer products, cosmetics, fragile goods, coins and collectibles, apparel, telecommunications, consumer electronics and consumer packaged goods, among others.

In the Service Fee model, we typically charge for our services on a cost-plus basis, a percent of shipped revenue basis, a time and materials, project or retainer basis for our professional services, or a per-transaction basis, such as a per-labor hour 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 the Agent or Flash, financial model, in which our clients maintain ownership of the product inventory stored at our locations as in the Service Fee 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 net of cost of product revenue as a component of service fee revenue in our condensed consolidated statement of operations.

Finally, our Retail model allows us to purchase inventory from the client. 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. In this model, depending on the terms of our client arrangements, we may 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. Depending on the terms of our client arrangements in the Retail model, we record in our condensed consolidated statement of operations either: 1) product revenue as a component of product revenue, or 2) product revenue net of cost of product revenue as a component of service fee revenue. In general, we seek to structure client relationships in our Retail model under the net revenue approach to more closely align with our service fee revenue financial presentation and mitigate inventory ownership, although we have one client still utilizing the gross revenue approach. Freight costs billed to customers are reflected as components of product revenue. This business model generally requires significant working capital, for which we have credit available either through credit terms provided by our clients or under senior credit facilities.

In general, we provide the Service Fee model through our all of our subsidiaries, the Agent (or Flash) model through our PFS and Supplies Distributors subsidiaries and the Retail model through our Supplies Distributors subsidiary.

Growth is a key element to achieving our future goals, including achieving and maintaining sustainable profitability. Growth in our Service Fee 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 four primary target markets, health and beauty, home goods and collectibles, fashion and consumer packaged goods, which, by nature, require a longer duration to close but also have the potential to be higher quality and longer duration engagements. The acquisitions of Moda in June 2015, CrossView in August 2015 and Conexus in June 2016 expanded our service offering capabilities and added new client relationships, which we currently expect to enhance our growth opportunities.

Currently, we are targeting any growth within our Retail model to be through relationships with clients under which we can record service fee revenue (product revenue net of product cost of revenue) in our condensed consolidated statement of operations as opposed to product revenue as generated in the Agent or Flash model above. These relationships are often driven by the sales and marketing efforts of the manufacturers and third party sales partners. In addition, as a result of certain operational restructuring of its business, our primary client relationship operating in the Retail model, Ricoh, has implemented, and will continue to implement, certain changes in the sale and distribution of Ricoh products. These changes have resulted, and are expected to continue to result, in reduced product revenues and profitability under our Retail model.

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 to help generate growth.

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

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, digital agency and technology 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 product revenue - 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 distributor agreements.

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.

Results of Operations for the Interim Periods Ended September 30, 2016 and 2015

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):

	For the Three Months Ended September 30,			% of Net Revenues		For the Nine Months Ended September 30,					
	2016	2015	Change	2016	2015	2016	2015	Change	2016	2015	
Revenues											
Service fee revenue	\$53.8	\$45.5	\$ 8.3	67.3 %	64.0 %	\$154.2	\$121.3	\$ 32.9	66.4 %	61.2 %	
Product revenue, net	11.7	14.4	(2.7)	14.6 %	20.3 %	36.7	44.7	(8.0)	15.8 %	22.6 %	
Pass-through revenue	14.5	11.2	3.3	18.1 %	15.8 %	41.3	32.2	9.1	17.8 %	16.2 %	
Total net revenues	80.0	71.1	8.9	100.0%	100.1%	232.2	198.2	34.0	100.0 %	100.0 %	
Cost of Revenues											
Cost of service fee											
revenue (1)	36.9	30.2	6.7	68.6 %	66.3 %	103.5	82.0	21.5	67.1 %	67.6 %	
Cost of product revenue											
(2)	11.0	13.7	(2.7)	94.2 %	95.0 %	34.6	42.3	(7.7)	94.5 %	94.6 %	
Pass-through cost of											
revenue (3)	14.5	11.2	3.3	100.0%	100.0%	41.3	32.2	9.1	100.0 %	100.0 %	
Total cost of revenues	62.4	55.1	7.3	78.0 %	77.4 %	179.4	156.5	22.9	77.3 %	78.9 %	
Service fee gross profit	16.9	15.3	1.6	31.4 %	33.7 %	50.7	39.3	11.4	32.9 %	32.4 %	
Product revenue gross											
profit	0.7	0.7	—	5.8							