PFSWEB INC
Form 10-Q
August 14, 2006

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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 June 30, 2006

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	7**5074**
(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 check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer o Non-accelerated filer 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 August 8, 2006 there were 46,451,443 shares of registrant s common stock outstanding, excluding 86,300 shares of common stock in treasury.

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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)

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 17,553	$ 13,683
Restricted cash	1,406	2,077
Accounts receivable, net of allowance for doubtful accounts of $1,875 and $484 at June 30, 2006 and December 31, 2005, respectively	48,538	44,556
Inventories, net	57,519	43,654
Other receivables	9,816	9,866
Prepaid expenses and other current assets	3,223	3,213
Total current assets	138,055	117,049
PROPERTY AND EQUIPMENT, net	13,525	13,040
RESTRICTED CASH		150
IDENTIFIABLE INTANGIBLES	7,316	
GOODWILL	18,545	
OTHER ASSETS	836	1,487
Total assets	$ 178,277	$ 131,726
LIABILITIES AND SHAREHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt and capital lease obligations	$ 27,709	$ 21,626
Trade accounts payable	70,718	60,053
Accrued expenses	18,667	12,011
Total current liabilities	117,094	93,690
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current Portion	1,892	6,289
OTHER LIABILITIES	1,432	1,813
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; 75,000,000 shares authorized; 46,526,100 and 22,613,314 shares issued at June 30, 2006 and December 31, 2005, respectively; and 46,439,800 and 22,527,014 outstanding at June 30, 2006 and December 31, 2005, respectively	47	23
Additional paid-in capital	90,858	58,736
Accumulated deficit	(34,595)	(29,824)
Accumulated other comprehensive income	1,634	1,084
Treasury stock at cost, 86,300 shares	(85)	(85)
Total shareholders equity	57,859	29,934
Total liabilities and shareholders equity	$ 178,277	$ 131,726

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
REVENUES:				
Product revenue, net	$ 89,650	$ 63,438	$ 179,854	$ 127,068
Service fee revenue	16,209	16,298	32,128	30,383
Pass-through revenue	3,445	5,134	7,990	9,284
Total net revenues	109,304	84,870	219,972	166,735
COSTS OF REVENUES:				
Cost of product revenue	84,486	59,613	168,809	119,250
Cost of service fee revenue	11,366	12,102	22,745	22,870
Pass-through cost of revenue	3,445	5,134	7,990	9,284
Total costs of revenues	99,297	76,849	199,544	151,404
Gross profit	10,007	8,021	20,428	15,331
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	12,531	7,952	23,892	14,918
Income (loss) from operations	(2,524)	69	(3,464)	413
INTEREST EXPENSE, NET	517	474	948	793
Loss before income taxes	(3,041)	(405)	(4,412)	(380)
INCOME TAX EXPENSE	143	141	359	380
NET LOSS	$ (3,184)	$ (546)	$ (4,771)	$ (760)
NET LOSS PER SHARE:				
Basic and Diluted	$ (0.07)	$ (0.02)	$ (0.12)	$ (0.03)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic and Diluted	43,072	22,419	39,011	22,278

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

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (4,771)	$ (760)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,589	3,012
Loss on disposal of assets	143	
Provision for doubtful accounts	275	(68)
Provision for excess and obsolete inventory	452	
Deferred income taxes	(24)	30
Stock option expense	480	14
Changes in operating assets and liabilities:		
Restricted cash	879	
Accounts receivables	2,216	(2,948)
Inventories, net	(6,217)	(3,228)
Prepaid expenses, other receivables and other assets	975	237
Accounts payable, accrued expenses and other liabilities	3,030	(2,623)
Net cash provided by (used in) operating activities	1,027	(6,334)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(2,123)	(2,561)
Payment for purchase of eCOST, net of cash acquired	(1,299)	
Decrease in restricted cash	748	1,348
Net cash used in investing activities	(2,674)	(1,213)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on capital lease obligations	(692)	(580)
Decrease in restricted cash	247	837
Proceeds from issuance of common stock	4,888	1,940
Proceeds from debt, net	1,210	5,144
Net cash provided by financing activities	5,653	7,341
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	(136)	53
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	3,870	(153)
CASH AND CASH EQUIVALENTS, beginning of period	13,683	13,592

CASH AND CASH EQUIVALENTS, end of period	$ 17,553	$ 13,439
SUPPLEMENTAL CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Property and equipment acquired under capital leases	$ 708	$ 891

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

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

1. OVERVIEW AND BASIS OF PRESENTATION

PFSweb, Inc. and its subsidiaries, including Supplies Distributors, Inc., and eCOST.com, Inc., are collectively referred to as the Company; Supplies Distributors refers to Supplies Distributors, Inc. and its subsidiaries; eCOST refers to eCOST.com, Inc.; and PFSweb refers to PFSweb, Inc. and its subsidiaries excluding Supplies Distributors and eCOST.

PFSweb Overview

PFSweb is an international provider of integrated business process outsourcing services to major brand name companies seeking to maximize their supply chain efficiencies and to extend their traditional and e-commerce initiatives in the United States, Canada, and Europe. PFSweb offers such services as professional consulting, technology collaboration, managed web hosting and internet application development, order management, web-enabled customer contact centers, customer relationship management, financial services including billing and collection services and working capital solutions, information management, facilities and operations management, kitting and assembly services, and international fulfillment and distribution services.

Supplies Distributors Overview

Supplies Distributors acts as a master distributor of various products, primarily International Business Machines Corporation (IBM) product, under a master distributor agreement with IBM. Supplies Distributors has outsourced to PFSweb the transaction management and fulfillment service functions of its distribution business and has outsourced to a third party the sales and marketing functions. Supplies Distributors sells its products in the United States, Canada and Europe.

eCOST Overview

eCOST is a multi-category online discount retailer of new, close-out and refurbished brand-name merchandise, selling products primarily to customers in the United States. eCOST offers products in several merchandise categories, including computer hardware and software, home electronics, digital imaging, watches and jewelry, housewares, DVD movies, video games, travel, bed and bath, apparel and accessories, licensed sports gear and cellular/wireless. eCOST carries products from leading manufacturers such as Apple, Canon, Citizen, Denon, Hewlett-Packard (HP), Nikon, Onkyo, Seiko and Toshiba.

Acquisition of eCOST

Effective February 1, 2006, a wholly-owned subsidiary of PFSweb merged with and into eCOST, with eCOST surviving the merger as a wholly-owned subsidiary of PFSweb. Each of the 18,858,132 issued and outstanding shares of common stock of eCOST were converted into one share of common stock of the Company. In conjunction with the merger, PFSweb assumed 36,210 warrants previously issued to a former eCOST warrantholder with an exercise price of $2.00 per share, subject to the terms set forth therein. As a result of the merger, effective February 1, 2006, PFSweb began consolidating 100% of eCOST s financial position and results of operations into PFSweb s consolidated financial statements. The following table presents selected pro forma information, for comparative purposes, assuming the acquisition had occurred on January 1 for the periods presented (unaudited) (in thousands):

	Three Months Ended		Six Months Ended	
	2006	2005	2006	2005
Net revenues	$109,304	$125,918	$232,906	$262,839
Net loss	(3,184)	(3,665)	(6,361)	(6,908)
Basic and diluted loss per share	(.07)	(.09)	(.16)	(.17)

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PFSweb, Inc. and Subsidiaries
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The unaudited pro forma information combines the historical unaudited consolidated statements of the Company s operations and eCOST s operations for the three and six months ended June 30, 2006 and 2005 giving effect to the merger and related events as if they had been consummated on January 1 for the periods presented. Pro forma adjustments have been made to reflect the amortization expense relating to the finite lives of certain acquired intangibles, such as trademark name and customer relationships and the reversal of the income tax expense recognized by eCOST in the three and six months ended June 30, 2005.

The unaudited pro forma information does not reflect significant operational and administrative cost savings, which are referred to as synergies, that management estimates may be achieved as a result of the merger transaction, or other incremental costs that may be incurred as a direct result of the merger transaction. The unaudited pro forma net revenue 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 eCOST during the periods noted.

The transaction was accounted for using the purchase method of accounting for business combinations and, accordingly, the results of operations of eCOST have been included in the Company s consolidated financial statements since the date of acquisition. For purposes of computing the purchase price, the value of the 18.9 million shares of PFSweb common stock issued was $1.42 per common share, based on the average closing price of PFSweb s common stock on NASDAQ for the period beginning two days prior to the consummation of the merger and ending on the consummation of the merger. The following table summarizes the preliminary unaudited, estimated fair value of the assets acquired and liabilities assumed as of February 1, 2006. The Company is in the process of finalizing the purchase price allocation and, accordingly, the allocation of the purchase price is subject to adjustment (in thousands):

Cash and restricted cash	$ 1,053
Accounts receivable, net	5,767
Inventories	6,898
Identifiable intangibles	7,657
Property and equipment	700
Other assets	322
Total assets acquired	22,397
Trade accounts payable	8,804
Accrued expenses	3,267
Other liabilities	793
Total liabilities assumed	12,864
Net assets acquired	9,533
Estimated purchase price	28,078
Goodwill acquired	$ 18,545

Estimated purchase price for eCOST is as follows (in thousands):

Number of shares of common stock issued	18,858
Multiplied by PFSweb s stock price	$ 1.42
Share consideration	$ 26,778

Estimated transaction costs	1,300
Estimated purchase price	$ 28,078

The above purchase price has been preliminarily allocated based on estimates of the fair values of assets acquired and liabilities assumed. The final valuation of net assets is expected to be completed as soon as possible, but no later than one year from the acquisition date.

The excess of the purchase price over the fair value of the net assets acquired and liabilities assumed was allocated to goodwill. The total goodwill of $18.5 million, none of which is deductible for tax purposes, is not being amortized but is subject to an impairment test each year using a fair-value-based

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approach pursuant to SFAS No. 142. The Company is amortizing the identifiable intangible assets acquired on a straight-line basis over their estimated remaining useful lives.

Basis of Presentation

The unaudited interim condensed consolidated financial statements as of June 30, 2006, and for the three and six months ended June 30, 2006 and 2005, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and are unaudited. Certain information and footnote 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 condensed consolidated financial statements of the Company include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the Company s financial position as of June 30, 2006, its results of operations for the three and six months ended June 30, 2006 and 2005 and its results of cash flows for the six months ended June 30, 2006 and 2005. Results of the Company s operations for interim periods may not be indicative of results for the full fiscal year.

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 in conformity with generally accepted accounting principles requires management to make 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 operating expenses in these consolidated financial statements also require management estimates and assumptions. The Company s estimates and assumptions are continually evaluated based on available information and experience. Because the use of estimates is inherent in the financial reporting process, actual results could differ from estimates.

Revenue Recognition

Net sales include product sales, gross outbound shipping charges, and related handling fees, and to a lesser extent, third-party extended warranties and other services. eCOST recognizes revenue from product sales, net of estimated returns, promotional discounts, credit card fraud and chargebacks, and coupon redemptions, when both title and risk of loss to the products has transferred to the customer, which eCOST has determined to occur upon receipt of products by the customer. eCOST generally requires payment by credit card upon placing an order, and to a lesser extent, grants credit to business customers on normal credit terms.

eCOST periodically provides incentive offers to customers including percentage discounts off current purchases. Such discounts are recorded as a reduction of the related purchase price at the time of sale based on actual and estimated redemption rates. Future redemption rates are estimated using eCOST s historical experience for similar sales inducement offers.

For product sales shipped directly from eCOST s vendors to end customers, eCOST records revenue and related costs at the gross amounts charged to the customer and paid to the vendor based on an evaluation of the criteria outlined in EITF No. 99-19, *Reporting Revenue Gross as a Principal Versus Net as an Agent*. eCOST s evaluation is performed based on a number factors, including whether eCOST is the primary obligor in the transaction, has latitude in establishing prices and selecting suppliers, takes title to the products sold upon shipment, bears credit risk, and bears inventory risk for returned products that are

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not successfully returned to third-party suppliers. eCOST recognizes revenue on extended warranties and other services for which it is not the primary obligor on a net basis.

Investment in Affiliates

Priority Fulfillment Services, Inc. (PFS), a wholly-owned subsidiary of PFSweb, has loaned Supplies Distributors and eCOST $6.5 million and $3.5 million, respectively, as of June 30, 2006, which are eliminated in consolidation. Under the terms of certain of the Company s debt facilities, the outstanding balance of the Supplies Distributors loan cannot be increased to more than $8.0 million or decreased to less than $6.5 million without prior approval of the Company s lenders and the outstanding balance of the eCOST loan amount cannot be less than $2.0 million without prior approval of eCOST s lender or increased above $3.5 million without the approval of PFS lender. Additionally, PFSweb loaned eCOST $2.5 million during the second quarter of 2006, which remained outstanding as of June 30, 2006.

Concentration of Business and Credit Risk

Supplies Distributors product revenue was primarily generated by sales to customers of product purchased under master distributor agreements with one supplier. The Company s service fee revenue is generated under contractual service fee relationships with multiple client relationships. There were no clients or customers that exceeded 10% of consolidated revenue during the 2006 or 2005 periods. A summary of the customer and client concentrations is as follows:

	Six Months Ended	
	June 30, 2006	**June 30, 2005**
Product Revenue (as a percentage of Product Revenue):		
Customer 1	11%	13%
Customer 2	9%	11%
Customer 3	8%	11%
Service Fee Revenue (as a percentage of Service Fee Revenue):		
Client 1	25%	32%
Client 2	19%	14%
Client 3	12%	12%
Accounts Receivable:		
1 Customer	13%	13%

PFSweb has provided certain guarantees of its subsidiaries financings and credit arrangements. These subsidiaries ability to obtain financing or credit arrangements on similar terms would be significantly impacted without these guarantees. Additionally, since Supplies Distributors has limited personnel and physical resources, its ability to conduct business could be materially impacted by any termination of its contract with the party performing product demand generation for the IBM products sold by Supplies Distributors.

The Company has multiple arrangements with IBM and is dependent upon the continuation of such arrangements. These arrangements, which are critical to the Company s ongoing operations, include Supplies Distributors master distributor agreements, certain of Supplies Distributors working capital financing agreements, product sales to IBM business units and a term master lease agreement.

eCOST s arrangements with its vendors are terminable by either party at will. Loss of any vendors could have a material adverse effect on its financial position, results of operations and cash flows. Sales of HP and HP-related products represented 31% of eCOST s net revenues, or 7% of consolidated net revenues, in

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the six months ended June 30, 2006.

Cash and Cash Equivalents

Cash equivalents are defined as short-term highly liquid investments with original maturities of three months or less.

Accounts Receivable

Accounts receivable consist primarily of amounts due from customers/clients to whom the Company has extended credit as well as amounts due from vendors related to co-op advertising costs. The Company records vendor receivables at such time as all conditions have been met that would entitle the Company to receive such vendor funding and is thereby considered fully earned.

The Company maintains an allowance for doubtful accounts receivable based upon estimates of future collection. The Company regularly evaluates customers financial condition and credit history in determining the adequacy of the allowance for doubtful accounts. The Company also maintains an allowance for uncollectible vendor receivables, which arise from vendor rebate programs, price protections and other promotions. The Company determines the sufficiency of the vendor receivable allowance based upon various factors, including payment history. If estimated allowances for uncollectible accounts or vendor receivables subsequently prove insufficient, additional allowances may be required.

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 potential declines in values due to inventories that are potentially slow moving or obsolete, potential excess levels of inventory or values assessed at potentially lower than cost.

Supplies Distributors assumes responsibility for slow-moving inventory under certain 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 PFSweb, Supplies Distributors and IBM 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.

Supplies Distributors inventories include merchandise in-transit that has not been received by the Company but that has been shipped and invoiced by Supplies Distributors vendors. The corresponding payable for inventories in-transit is included in accounts payable in the accompanying consolidated financial statements.

eCOST inventories include goods in-transit to customers.

The allowance for slow moving inventory was $1.9 million and $1.5 million at June 30, 2006 and December 31, 2005, respectively.

Property and Equipment

The Company s property held under capital leases amounted to approximately $3.4 million and $3.3 million, net of accumulated amortization of approximately $9.0 million and $8.3 million, at June 30, 2006 and December 31, 2005, respectively.

Advertising Costs

eCOST produces and circulates catalogs at various dates throughout the year and receives market development funds and co-op advertising funds from vendors included in each catalog. Pursuant to

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Statement of Position (SOP) 93-7, *Reporting on Advertising Costs*, the costs of developing, producing and circulating each catalog are deferred and charged to advertising expense ratably over the life of the catalog based on the revenue generated from each catalog, approximately eight weeks. Advertising expenses for eCOST, including those for catalog, internet and other methods, were $1.9 million for the period from the eCOST acquisition date through June 30, 2006 and are included in selling, general and administrative expenses. There were no such expenses to the Company prior to the acquisition of eCOST.

Market development and co-op advertising funds pursuant to Emerging Issues Task Force (EITF) 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received form a Vendor*, are recognized as an offset to cost of goods sold. Direct market development and co-op funds for eCOST were $1.1 million for the period from the acquisition date through June 30, 2006. There were no such funds recognized by the Company prior to the acquisition of eCOST.

Intangible Assets

Intangible assets acquired consisted of the following as of June 30, 2006 (in thousands):

	Amortization Period	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	8 years	$ 2,072	$ (108)	$ 1,964
Trademark/Domain name	10 years	5,585	(233)	5,352
Total intangible assets		$ 7,657	$ (341)	$ 7,316

3. COMPREHENSIVE LOSS (in thousands)

	Three Months Ended June 30		Six Months Ended June 30	
	2006	2005	2006	2005
Net loss	$ (3,184)	$ (546)	$ (4,771)	$ (760)
Other comprehensive loss:				
Foreign currency translation adjustment	348	(544)	551	(1,087)
Comprehensive loss	$ (2,836)	$ (1,090)	$ (4,220)	$ (1,847)

4. NET LOSS PER COMMON SHARE

Basic and diluted net loss per share is computed by dividing net loss available to common shareholders by the weighted-average number of common shares outstanding for the reporting period. For the three months ended June 30, 2006 and 2005 and the six months ended June 30, 2006 and 2005, outstanding options of 6.1 million, 5.5 million, 6.1 million and 5.5 million, respectively, to purchase common shares were anti-dilutive and have been excluded from the weighted diluted average share computation. Warrants not included in the calculation of diluted net loss per share for the three and six months ended June 30, 2006 were 601,190 and for the three and six months ended June 30, 2005 were 395,486 as the effect would be anti-dilutive. Outstanding warrants have been adjusted to give effect to the recent merger with eCOST and the sale by the Company of 5,000,000 shares of common stock on June 1, 2006 in a private placement transaction.

5. STOCK AND STOCK OPTIONS

Private Placement Transaction

In June 2006, the Company entered into a Purchase Agreement and Registration Rights Agreement with certain institutional investors in a private placement transaction pursuant to which the Company issued and sold an aggregate of 5,000,000 shares of its common stock, par value $.001 per share (the Common Stock), a