PFSWEB INC
Form 10-Q
November 14, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2013

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	75-2837058
(State of Incorporation)	(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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by 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 x 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 x

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

At November 11, 2013 there were 16,307,901 shares of registrant s common stock outstanding.

PFSweb, Inc. and Subsidiaries

Form 10-Q

September 30, 2013

INDEX

PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

PFSweb, Inc. and Subsidiaries

UNAUDITED CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)

	September 30, 2013		December 31, 2012	
ASSETS				
CURRENT ASSETS:				
Cash and cash equivalents	$	21,293	$	19,626
Restricted cash		466		283
Accounts receivable, net of allowance for doubtful accounts of $367 and $450 at September 30, 2013 and December 31, 2012, respectively		37,715		45,684
Inventories, net of reserves of $1,688 and $1,789 at September 30, 2013 and December 31, 2012, respectively		17,326		24,654
Other receivables		7,645		7,675
Prepaid expenses and other current assets		4,590		4,346
Total current assets		89,035		102,268
PROPERTY AND EQUIPMENT, net		26,667		27,917
OTHER ASSETS		2,880		3,286
Total assets	$	118,582	$	133,471
LIABILITIES AND SHAREHOLDERS EQUITY				
CURRENT LIABILITIES:				
Current portion of long-term debt and capital lease obligations	$	8,820	$	16,660
Trade accounts payable		26,153		40,493
Deferred revenue		9,166		6,648
Accrued expenses		21,299		23,097
Total current liabilities		65,438		86,898
LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS, less current portion		3,473		5,400
DEFERRED REVENUE		6,177		7,562
DEFERRED RENT		5,142		5,560
Total liabilities		80,230		105,420
COMMITMENTS AND CONTINGENCIES				
SHAREHOLDERS EQUITY:				
Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued or outstanding				
		16		13

Common stock, $0.001 par value; 35,000,000 shares authorized; 16,199,431 and 12,812,386 shares issued at September 30, 2013 and December 31, 2012, respectively; and 16,165,964 and 12,778,919 outstanding at September 30, 2013 and December 31, 2012, respectively		
Additional paid-in capital	121,663	106,018
Accumulated deficit	(84,891)	(79,409)
Accumulated other comprehensive income	1,689	1,554
Treasury stock at cost, 33,467 shares	(125)	(125)
Total shareholders equity	38,352	28,051
Total liabilities and shareholders equity	$ 118,582	$ 133,471

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

PFSWEB, INC. AND SUBSIDIARIES

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands, Except Per Share Data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
REVENUES:				
Product revenue, net	$ 21,495	$ 27,476	$ 69,660	$ 91,450
Service fee revenue	23,908	28,260	78,708	85,022
Pass-through revenue	8,150	9,018	26,511	28,121
Total revenues	53,553	64,754	174,879	204,593
COSTS OF REVENUES:				
Cost of product revenue	20,221	25,538	65,215	84,483
Cost of service fee revenue	16,196	20,777	53,265	63,130
Cost of pass-through revenue	8,150	9,018	26,511	28,121
Total costs of revenues	44,567	55,333	144,991	175,734
Gross profit	8,986	9,421	29,888	28,859
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES, including stock based compensation expense of $610 and $308 in the three months ended September 30, 2013 and 2012, respectively, and $1,195 and $1,014 in the nine months ended September 30, 2013 and 2012, respectively.	10,656	9,401	34,395	29,807
Income (loss) from operations	(1,670)	20	(4,507)	(948)
INTEREST EXPENSE, net	162	236	564	758
Loss from operations before income taxes	(1,832)	(216)	(5,071)	(1,706)
INCOME TAX EXPENSE	120	154	411	457
NET LOSS	$ (1,952)	$ (370)	$ (5,482)	$ (2,163)
NET LOSS PER SHARE:				
Basic	$ (0.12)	$ (0.03)	$ (0.38)	$ (0.17)
Diluted	$ (0.12)	$ (0.03)	$ (0.38)	$ (0.17)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING:				
Basic	16,121	12,783	14,490	12,777
Diluted	16,121	12,783	14,490	12,777
COMPREHENSIVE INCOME (LOSS):				
Net loss	$ (1,952)	$ (370)	$ (5,482)	$ (2,163)
Foreign currency translation adjustment	275	235	135	14
TOTAL COMPREHENSIVE INCOME (LOSS)	$ (1,677)	$ (135)	$ (5,347)	$ (2,149)

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

PFSweb, Inc. and Subsidiaries

UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

	Nine Months Ended September 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (5,482)	$ (2,163)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	7,533	6,834
Provision for doubtful accounts	18	(131)
Provision for excess and obsolete inventory	56	249
Deferred income taxes	47	(6)
Stock-based compensation expense	1,195	1,014
Changes in operating assets and liabilities:		
Restricted cash	2	(30)
Accounts receivable	8,087	14,806
Inventories	7,307	4,821
Prepaid expenses, other receivables and other assets	152	3,693
Deferred rent	(344)	5,420
Accounts payable, deferred revenue, accrued expenses and other liabilities	(15,203)	(14,803)
Net cash provided by operating activities	3,368	19,704
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(5,245)	(11,048)
Net cash used in investing activities	(5,245)	(11,048)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from issuance of common stock	14,453	48
Purchase of treasury stock		(36)
Decrease (increase) in restricted cash	(185)	386
Payments on capital lease obligations	(1,991)	(1,508)
Payments on long-term debt, net	(8,768)	(7,427)
Net cash provided by (used in) financing activities	3,509	(8,537)
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	35	(21)
NET INCREASE IN CASH AND CASH EQUIVALENTS	1,667	98
CASH AND CASH EQUIVALENTS, beginning of period	19,626	17,695
CASH AND CASH EQUIVALENTS, end of period	$ 21,293	$ 17,793

SUPPLEMENTAL CASH FLOW INFORMATION		
Non-cash investing and financing activities:		
Property and equipment acquired under long-term debt and capital leases	$ 1,338	$ 6,229

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

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

1. OVERVIEW AND BASIS OF PRESENTATION

PFSweb, Inc. and its subsidiaries are collectively referred to as the Company; Supplies Distributors refers to Supplies Distributors, Inc. and its subsidiaries; Retail Connect refers to PFSweb Retail Connect, Inc.; and PFSweb refers to PFSweb, Inc. and its subsidiaries and affiliates, excluding Supplies Distributors and Retail Connect.

PFSweb Overview

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

Supplies Distributors Overview

Supplies Distributors and PFSweb operate under distributor agreements with Ricoh Company Limited and Ricoh Production Print Solutions, 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. Substantially all of Supplies Distributors revenue is generated by its sale of product purchased from Ricoh.

Supplies Distributors has obtained financing that allows it to fund the 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.

All of the agreements between PFSweb and Supplies Distributors were made in the context of a related party relationship and were negotiated in the overall context of PFSweb s and Supplies Distributors arrangement with Ricoh. 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 unaudited interim consolidated financial statements as of September 30, 2013, and for the three and nine months ended September 30, 2013 and 2012, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) and are unaudited. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (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 consolidated financial statements of the Company include all adjustments necessary for a fair presentation of the Company s financial position as of September 30, 2013, its results of operations for the three and nine months ended September 30, 2013 and 2012 and its cash flows for the nine months ended September 30, 2013 and 2012. Results of the Company s operations for interim periods may not be indicative of results for the full fiscal year.

Certain prior period data on the income statement has been reclassified to conform to the current year presentation of a) product and pass-through revenues, b) cost of product, service fee and pass-through revenues and c) selling, general and administrative expenses, each of which was previously classified as a different component on the income statement. These reclassifications decreased gross profit and selling, general and administrative expenses by $0.4 million and $1.1 million for the three and nine months ended September 30, 2012, respectively, but had no effect on previously reported net loss, total shareholders equity or net cash provided by operating activities.

2. SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of 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 consolidated financial statements also require management estimates and assumptions.

Estimates and assumptions about future events and their effects cannot be determined with certainty. The Company bases its estimates on historical experience and on various other assumptions believed to be applicable and reasonable under the circumstances. These estimates may change as new events occur, as additional information is obtained and as the operating environment changes. These changes have been included in the consolidated financial statements as soon as they became known. In addition, management is periodically faced with uncertainties, the outcomes of which are not within its control and will not be known for prolonged periods of time. These uncertainties are discussed in this report and in the Company s Annual Report on Form 10-K for the year ended December 31, 2012 in the section entitled Risk Factors. Based on a critical assessment of accounting policies and the underlying judgments and uncertainties affecting the application of those policies, management believes the Company s consolidated financial statements are fairly stated in accordance with U.S. GAAP, and provide a fair presentation of the Company s financial position and results of operations.

Investment in 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 the Company s debt facilities, the outstanding balance of the Subordinated Note cannot be increased to more than $5.0 million or decreased to less than $3.5 million without prior approval of certain of the Company s lenders. As of both September 30, 2013 and December 31, 2012, the outstanding balance of the Subordinated Note was $3.5 million. The Subordinated Note is eliminated in the Company s consolidated financial statements.

PFS has also made advances to Retail Connect, which aggregated $11.1 million at both September 30, 2013 and December 31, 2012. Certain terms of the Company s debt facilities provide that the total advances to Retail Connect may not be less than $2.0 million without prior approval of Retail Connect s lender, if needed. PFS has received the approval of its lender to advance incremental amounts to certain of its subsidiaries and/or affiliates, including Retail Connect, if needed, subject to certain financial covenants, as defined. PFSweb, Inc. has also advanced to Retail Connect an additional $8.5 million and $8.2 million as of September 30, 2013 and December 31, 2012, respectively. All of these advances are eliminated upon consolidation. As of September 30, 2013, PFSweb, Inc. has approximately $12.6 million available to be advanced to Retail Connect and/or other affiliates.

Concentration of Business and Credit Risk

No service fee client or product revenue customer represented more than 10% of the Company s consolidated total net revenues during the nine months ended September 30, 2013 or the Company s consolidated accounts receivable as of September 30, 2013.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

A summary of the nonaffiliated customer and client concentrations is as follows:

	Nine Months Ended September 30,	
	2013	2012
Product Revenue (as a percentage of total Product Revenue):		
Customer 1	15 %	14%
Customer 2	12 %	11%
Service Fee Revenue (as a percentage of total Service Fee Revenue):		
Client 1	10 %	14%
Client 2	8 %	16%

The Company currently anticipates that its product revenue and service fee revenue from the customers and clients identified above will decline during the next twelve months and the contractual relationship with Client 1 ended during the quarter ended September 30, 2013.

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.

The Company has multiple arrangements with International Business Machines Corporation (IBM) and Ricoh and is dependent upon the continuation of such arrangements. These arrangements, which are critical to the Company s ongoing operations, include Supplies Distributors distributor agreements and certain of Supplies Distributors working capital financing agreements. Substantially all 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 in 2013 and beyond.

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 and corporate offices, as well as certain equipment, under non-cancelable operating leases that expire at various dates through 2022. 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 consolidated balance sheets.

Property and Equipment

The Company s property held under capital leases amounts to approximately $4.2 million and $5.1 million, net of accumulated amortization of approximately $4.5 million and $2.6 million, at September 30, 2013 and December 31, 2012, respectively. Depreciation and amortization expense related to capital leases during the nine months ended September 30, 2013 and 2012 was $2.0 million and $1.5 million, respectively. In addition, during 2012, the Company incurred approximately $6.0 million of leasehold improvements at certain of its leased facilities that are being amortized over the shorter of the asset s useful lives or the lease terms and were primarily financed via tenant allowances that are also being amortized over the lease terms.

Income Taxes

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

Cash Paid for Interest and Taxes

The Company made payments for interest of approximately $0.6 million and $0.8 million in the nine months ended September 30, 2013 and 2012, respectively. Income taxes of approximately $0.1 and $0.4 million were paid by the Company during the nine month periods ended September 30, 2013 and 2012, respectively.

3. NET LOSS PER COMMON SHARE

Basic and diluted net loss per share are computed by dividing net loss by the weighted-average number of common shares outstanding for the reporting period. Stock options not included in the calculation of diluted net loss per share for the nine months ended September 30, 2013, and 2012 were 2.2 million and 2.1 million, respectively, as the effect would be anti-dilutive.

4. STOCK AND STOCK OPTIONS

In May 2013, the Company completed an equity offering pursuant to which the Company sold an aggregate of 3.2 million shares of common stock, par value $0.001 per share, at $4.57 per share, resulting in net proceeds, after deducting offering expenses, of approximately $14.1 million.

On May 22, 2013, pursuant to the Company s 2005 Employee Stock and Incentive Plan, as amended and restated (the Plan), the Company issued Performance-Based Share Awards (Performance Shares , as defined in the Plan) to certain of the Company s executives. The number of Performance Shares that each such individual may receive is subject to, and calculated by reference to, the achievement by the Company of certain 2013 financial targets. Based on the financial targets, the aggregate maximum number of Performance Shares that may be issued for 2013 is 0.7 million. The Performance Shares are subject to four year vesting based upon continued employment and the comparative performance (on an annual and cumulative basis) of the Company s common stock on NASDAQ compared to the Russell Micro Cap Index. Stock compensation charged against income related to the Performance Shares was $0.3 million in the nine months ended September 30, 2013.

During the nine months ended September 30, 2013 and 2012, the Company issued an aggregate of 306,000 and 73,000 options, respectively, to purchase shares of common stock to officers, directors, employees and consultants of the Company.

5. 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 $20.0 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 $12.1 million and $11.9 million as of September 30, 2013 and December 31, 2012, respectively, as accounts payable in the consolidated balance sheets. As of September 30, 2013, Supplies Distributors had $1.4 million of 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 $3.5 million and the Company is required to maintain a minimum shareholders equity of $18.0 million. Borrowings under the credit facility accrue interest, after a defined free financing period, at prime rate plus 0.5% (3.75% as of September 30, 2013). The facility also includes a monthly service fee.

PFSweb, Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

6. DEBT AND CAPITAL LEASE OBLIGATIONS;

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

	September 30, 2013	December 31, 2012
Loan and security agreements		
Supplies Distributors	$ 4,691	$ 3,264
PFS	1,749	11,077
Credit facility Retail Connect		
Master lease agreements	5,404	6,648
Other	449	1,071
Total	12,293	22,060
Less current portion of long-term debt	8,820	16,660
Long-term debt, less current portion	$ 3,473	$ 5,400

Loan and Security Agreement Supplies Distributors

Supplies Distributors has a loan and security agreement with Wells Fargo Bank, National Association (Wells Fargo) to provide financing for up to $25 million of eligible accounts receivable in the United States and Canada. As of September 30, 2013, Supplies Distributors had $0.8 million of available credit under this agreement. The Wells Fargo facility expires on the earlier of March 2014 or the date on which the parties to the Ricoh distributor agreement no longer operate under the terms of such agreement and/or Ricoh no longer supplies products pursuant to such agreement. Borrowings under the Wells Fargo facility accrue interest at prime rate plus 0.25% to 0.75% (3.75% as of September 30, 2013) or Eurodollar rate plus 2.5% to 3.0%, dependent on excess availability and subject to a minimum of 3.0%, as defined. The interest rate as of September 30, 2013 was 3.75% for $3.7 million of outstanding borrowings and 3.0% for $1.0 million of outstanding borrowings. As of December 31, 2012, the interest rate was 3.75% for $1.3 million of outstanding borrowings and 3.0% for $2.0 million of outstanding borrowings. This agreement contains cross default provisions, various restrictions upon the ability of Supplies Distributors to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans and payments to related parties (including 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. This agreement also contains financial covenants, such as minimum net worth, as defined, and is secured by all of the assets of Supplies Distributors, as well as a collateralized guaranty of PFSweb. Additionally, PFS is required to maintain a Subordinated Note receivable balance from Supplies Distributors of no less than $3.5 million, may not maintain restricted cash of more than $5.0 million and is restricted with regard to transactions with related parties, indebtedness and changes to capital stock ownership structure. Supplies Distributors has entered into blocked account agreements with its banks and Wells Fargo pursuant to which a security interest was granted to Wells Fargo for all U.S. and Canadian customer remittances received in specified bank accounts. At September 30, 2013 and December 31, 2012, these bank accounts held $0.4 million and $0.2 million, respectively, which were restricted for payment to Wells Fargo.

Loan and Security Agreement   PFS

PFS has a Loan and Security Agreement (Comerica Agreement) with Comerica Bank (Comerica). The Comerica Agreement provides for up to $12.5 million ($10.0 million during certain non-seasonal peak months) of eligible accounts receivable financing (Working Capital Advances) through March 2014. The Comerica Agreement also provided for up to $3.0 million of eligible equipment advances (Equipment Advances) through January 2013, with principal payments due through April 2015. As of September 30, 2013, PFS had $9.9 million of available credit under the Working Capital Advance portion of this facility and no remaining availability for Equipment Advances. Borrowings under the Working Capital Advance portion of the Comerica Agreement accrue interest at prime rate plus 2% (5.25% at September 30, 2013) while the Equipment Advances accrue interest at prime rate plus 2.25% (5.5% at September 30, 2013). The Comerica Agreement contains cross default provisions and various restrictions upon PFS ability 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.), make capital expenditures, make investments and loans, pledge assets, make changes to capital stock ownership structure, as well as financial covenants of a minimum tangible net worth of $20 million, as defined, a minimum earnings before interest and taxes, plus depreciation, amortization and non-cash compensation accruals, if any, as defined, and a minimum liquidity ratio, as defined. The Comerica Agreement restricts the amount of the Subordinated Note receivable from Supplies Distributors to a maximum of $5.0 million. Comerica has provided approval for PFS to advance incremental amounts subject to certain financial covenants, as defined, to certain of its subsidiaries and/or affiliates, if needed. The Comerica Agreement is secured by all of the assets of PFS, as well as a guarantee of PFSweb, Inc.

Credit Facility Retail Connect

Retail Connect has an asset-based line of credit facility of up to $2.0 million from Wells Fargo, through May 2014, which is collateralized by substantially all of Retail Connect s assets. Borrowings under the facility are limited to a percentage of eligible accounts receivable and inventory, up to a specified amount. Outstanding borrowings under the facility bear interest at prime rate plus 1% or Eurodollar rate plus 3.5%. There were no outstanding borrowings as of September 30, 2013. As of September 30, 2013, Retail Connect had $33,000 of available credit under this facility. In connection with the line of credit, Retail Connect entered into a cash management arrangement whereby Retail Connect s operating accounts are considered restricted and swept and used to repay outstanding amounts under the line of credit, if any. The credit facility restricts Retail Connect s ability to, among other things, merge, consolidate, sell assets, incur indebtedness, make loans, investments and payments to subsidiaries, affiliates and related parties (including entities directly or indirectly owned by PFSweb, Inc.), make investments and loans, pledge assets, make changes to capital stock ownership structure, and requires a minimum tangible net worth for Retail Connect of $0 million, as defined. PFSweb has guaranteed all current and future obligations of Retail Connect under this line of credit.

Factoring Agreement

Supplies Distributors European subsidiary has a factoring agreement with BNP Paribas Fortis Factor that provides factoring for up to 7.5 million euros (approximately $10.1 million as of September 30, 2013) of eligible accounts receivable through March 2014. This factoring agreement is accounted for as a secured borrowing. As of September 30, 2013, Supplies Distributors European subsidiary had approximately 0.9 million euros (approximately $1.2 million) of available credit under this agreement. Borrowings accrue interest at Euribor plus 0.7% (0.8% at September 30, 2013).

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 monthly 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 September 30, 2013, 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 Consolidated Financial Statements

7. SEGMENT INFORMATION

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenues (in thousands):				
PFSweb	$ 32,471	$ 38,312	$ 106,846	$ 116,763
Business and Retail Connect	23,592	27,619	75,610	91,901
Eliminations	(2,510)	(1,177)	(7,577)	(4,071)
	$ 53,553	$ 64,754	$ 174,879	$ 204,593
Income (loss) from operations (in thousands):				
PFSweb	$ (1,823)	$ (568)	$ (5,153)	$ (2,896)
Business and Retail Connect	153	588	646	1,948
	$ (1,670)	$ 20	$ (4,507)	$ (948)
Depreciation and amortization (in thousands):				
PFSweb	$ 2,399	$ 2,476	$ 7,417	$ 6,768
Business and Retail Connect	38	26	116	66
	$ 2,437	$ 2,502	$ 7,533	$ 6,834
Capital expenditures (in thousands):				
PFSweb	$ 2,028	$ 1,575	$ 5,174	$ 10,857
Business and Retail Connect	55	102	71	191
	$ 2,083	$ 1,677	$ 5,245	$ 11,048

	September 30, 2013	December 31, 2012
Assets (in thousands):		
PFSweb	$ 88,074	$ 94,940
Business and Retail Connect	45,225	52,648
Eliminations	(14,717)	(14,117)
	$ 118,582	$ 133,471

8. COMMITMENTS AND CONTINGENCIES

In 2012, the Company incurred approximately $6.0 million of costs related to leasehold improvements at certain of its leased facilities that are being amortized over the shorter of the assets   lives or the lease terms and were primarily financed via tenant allowances that are also being amortized over the lease terms.

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 payments has not been finalized. As of September 30, 2013, the Company believes it has adequately accrued for the expected assessment.

In April 2010, a sales employee of eCOST (the former name of Retail Connect) was charged with violating various federal criminal statutes in connection with the sales of eCOST products to certain customers, and approximately $620,000 held in an eCOST deposit account was seized and turned over to the Office of the U.S. Attorney in connection with such activity. The Company received subpoenas from the Office of the U.S. Attorney requesting information regarding the employee and other matters, and the Company responded to the subpoenas and is fully cooperating with the Office of the U.S. Attorney. In August 2012, the employee pleaded guilty to a misdemeanor. Neither the Company nor eCOST have been charged with any criminal activity, and the Company is seeking the recovery of the funds that are currently classified as other receivables on the September 30, 2013 financial statements. Based on the information available to date, the Company is unable to determine the amount of the loss, if any, relating to the seizure of such funds. No assurance can be given, however, that the seizure of such funds, or the inability of the Company to recover such funds or any significant portion thereof, or any costs and expenses incurred by the Company in connection with this matter will not have a material adverse effect upon the Company s financial condition or results of operations.

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

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

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

Forward-Looking Information

We have made forward-looking statements in this Report on Form 10-Q. These statements are subject to risks and uncertainties, and there can be no guarantee that these statements will prove to be correct. Forward-looking statements include assumptions as to how we may perform in the future. When we use words like seek, strive, believe, expect, anticipate, predict, potential, continue, will, may, could, intend, plan, target and estimate or si are making forward-looking statements. You should understand that the following important factors, in addition to those set forth above or elsewhere in this Report on Form 10-Q and our Form 10-K for the year ended December 31, 2012, could cause our results to differ materially from those expressed in our forward-looking statements. These factors include:

- our ability to retain and expand relationships with existing clients and attract and implement new clients;
- our reliance on the fees generated by the transaction volume or product sales of our clients;
- our reliance on our clients projections or transaction volume or product sales;
- our dependence upon our agreements with International Business Machines Corporation (IBM) and Ricoh Company Limited and Ricoh Production Print Solutions, 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 and manage growth;
- increased competition;
- our ability to generate more revenue and achieve sustainable profitability;
- effects of changes in profit margins;
- the customer and supplier concentration of our business;
- our reliance on third-party subcontracted services;
- the unknown effects of possible system failures and rapid changes in technology;
- foreign currency risks and other risks of operating in foreign countries;
- potential litigation;
- our dependency upon key personnel;
- the impact of new accounting standards, and changes in existing accounting rules or the interpretations of those rules;
- our ability to raise additional capital or obtain additional financing;
- our ability, and the ability of our subsidiaries, to borrow under current financing arrangements and maintain compliance with debt covenants;
- 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 actually will be achieved. In addition, some forward-looking statements are based upon assumptions as to future events that may not prove to be accurate. Therefore, actual outcomes and results may differ materially from what is expected or forecasted in such forward-looking statements. We undertake no obligation to update publicly any forward-looking statement for any reason, even if new information becomes available or other events occur in the future.

Overview

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

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

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

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

In general, we provide the Enablement and Agent (or Flash) models through our PFS and Supplies Distributors subsidiaries and the Retail model through our Supplies Distributors and PFSweb Retail Connect subsidiaries.

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

Currently, any growth within our Retail model would be primarily driven by our ability to attract new distributor arrangements with Ricoh or other manufacturers and the sales and marketing efforts of the manufacturers and third party sales partners. 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 under our Retail model in 2013 and beyond as compared to prior years.

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

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

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

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

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

Monitoring and controlling our available cash balances and our expenses continues to be a primary focus. Our cash and liquidity positions are important components of our financing of both current operations and our targeted growth. To improve our cash and liquidity position, in May 2013, we sold an aggregate of 3.2 million shares of our Common Stock at $4.57 per share, resulting in net proceeds of $14.1 million.

Results of Operations For the Interim Periods Ended September 30, 2013 and 2012

The following table discloses certain financial information for the periods presented, expressed in terms of dollars, dollar change, percentage change and as a percentage of total revenue (in millions):

	Three Months Ended September 30,					Nine Months Ended September 30,				
				% of Net Revenues					% of Net Revenues	
	2013	2012	Change	2013	2012	2013	2012	Change	2013	2012
Revenues										
Product revenue, net	$ 21.5	$ 27.5	$ (6.0)	40.1%	42.5%	$ 69.7	$ 91.5	$ (21.8)	39.8%	44.7%
Service fee revenue										