LAWSON PRODUCTS INC/NEW/DE/
Form 10-K
March 01, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2011

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission file number: 0-10546

LAWSON PRODUCTS, INC.

(Exact Name of Registrant as Specified in Charter)

Delaware	**36-2229304**
(State or other jurisdiction of	**(I.R.S. Employer**

incorporation or organization)	Identification No.)

1666 East Touhy Avenue, Des Plaines, Illinois 60018

(Address of principal executive offices)

Registrant s telephone number, including area code:

(847) 827-9666

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $1.00 par value	The NASDAQ Stock Market LLC (NASDAQ Global Select Market)

Securities registered pursuant to Section 12(g) of the Act:

None

(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No þ

Indicate by check mark whether the registrant (l) 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 ¨

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

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

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

The aggregate market value of the registrant s voting stock held by non-affiliates on June 30, 2011 (based upon the per share closing price of $19.67) was approximately $84,100,000.

As of January 31, 2012, 8,574,291 shares of Common Stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

The following documents are incorporated into this Form 10-K by reference:

Part III incorporates information by reference to the registrant s definitive proxy statement, to be filed with the Securities and Exchange Commission within 120 days after the close of the fiscal year.

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Safe Harbor Statement under the Securities Litigation Reform Act of 1995: This Annual Report on Form 10-K contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. The terms may, should, could, anticipate, believe, continues, estimate, expect, intend, objective, plan, potential, project intended to identify forward-looking statements. These statements are not guarantees of future performance and involve risks, uncertainties and assumptions that are difficult to predict. These statements are based on management s current expectations, intentions or beliefs and are subject to a number of factors, assumptions and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. Factors that could cause or contribute to such differences or that might otherwise impact the business include the risk factors set forth in Item 1A of this Form 10-K.

The Company undertakes no obligation to update any such factor or to publicly announce the results of any revisions to any forward-looking statements contained herein whether as a result of new information, future events or otherwise.

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PART I

ITEM 1. BUSINESS.

Overview

Lawson Products, Inc. (Lawson , the Company , we , our , or us) was incorporated in Illinois in 1952, and reincorporated in Delaware in 1 Lawson is a North American distributor of products and services to the industrial, commercial, institutional, and governmental maintenance, repair and operations (MRO) marketplace and also manufactures and distributes production and specialized component parts to the original equipment manufacturers (OEM) marketplace.

Industry and Competition

The MRO industrial distribution industry consists of companies that buy and stock products in bulk and supply these products to customers on an as needed basis. The customer benefits from lower costs and convenience of ordering smaller quantities maintained by MRO suppliers. We estimate the MRO industrial distribution industry in North America to exceed $100 billion in revenues.

There is a significant amount of fragmentation by geography and product within the industry. We encounter intense competition from several national distributors and manufacturers and a large number of regional and local distributors. Some competitors have greater financial and personnel resources, handle more extensive lines of merchandise, operate larger facilities and price some merchandise more competitively than we do.

We consider our large national competitors to be WW Grainger, Fastenal, McMaster Carr, MSC Industrial Direct, and Barnes Distribution. We compete for business in our industry by delivering on the value proposition we call Smarter Maintenance under which we offer a personal approach to vendor managed inventory, provide technical expertise and supply quality products to our customers.

Customers

Sales generated by our MRO segment represented over 95% of our total sales for the year ended December 31, 2011. Due to fewer selling days during the holiday season, net sales in the fourth quarter are historically lower than the first three quarters of the year. During 2011, we sold products to approximately 90,000 customers and no customer accounted for more than two percent of net sales. In 2011, 91% of our net sales were generated in the United States and 9% from Canada. Our customers operate in a variety of industries including automotive repair, commercial vehicle maintenance, government, manufacturing, food processing, distribution, construction, oil and gas, mining, wholesale, service and others.

Our customers include a wide range of purchasers of industrial supply products from small repair shops to large national and governmental accounts. Historically, we have been very effective at selling to and servicing small and medium sized customers. We are taking deliberate steps to gain a share of larger national accounts to expand our sales base. We have assembled a team of employee sales professionals to identify and prioritize strategic accounts, which we define as larger, multi-location national accounts. During 2011, strategic account sales grew by 18% over 2010 and represented approximately 10% of MRO net sales.

Operations

Customers place orders primarily through our independent sales representatives; however, they can also order directly from our website or through our customer service team via fax or phone. We sell products in all 50 states, the District of Columbia, Canada and Puerto Rico, and export products that support U.S. military efforts in Europe. An important factor in attracting and retaining customers is our ability to process orders promptly. We normally ship to our customers within one to two days of order placement.

Our MRO distribution process normally entails transporting product from our suppliers to our national packaging center for possible repackaging, labeling or cross-docking. Product is then shipped and stocked in strategically located distribution centers in Illinois, Nevada, New Jersey, Georgia, and Ontario where orders are picked, packed and shipped to our customers. Many factors affect the efficiency of this process including the physical characteristics of the distribution centers, routing logistics, the number of times the product needs to be handled, transportation costs and the flexibility to meet unique requirements requested by our customers.

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In 2011, we upgraded our business processes by completing a major phase of the implementation of a new Enterprise Resource Planning (ERP) system. The new ERP system integrates our revenue cycle, from initial order through cash receipt and the procurement cycle, from product sourcing through payment. ERP has replaced many of the diverse and aging legacy systems which have limited our operational capabilities in the past.

Our engineering department, as part of our Smarter Maintenance proposition, provides technical support for our products and offers on-site problem solutions. They also develop and present product safety and technical training seminars tailored to meet our customers needs. Material Safety Data Sheets are maintained electronically and are available to our customers 24 hours a day, seven days a week. Our labs provide us with the environment to solve technical problems remotely by simulating customer situations.

Products

Our MRO product offerings are listed on our website and in approximately 27,000 catalogs that were distributed to our customers in 2011. Our MRO products are manufactured by others, purchased in bulk and repackaged in smaller quantities for sale to our customers.

Sales percentages by broad categories of our MRO product mix in 2011 were as follows:

Product Category	**September 30, Percentage**
Fastening systems	21%
Specialty chemicals	15
Cutting tools and abrasives	14
Fluid power	13
Electrical	11
Aftermarket automotive supplies	5
Welding and metal repair	4
Safety	3
Other	14
	100%

We offer over 300,000 different products for sale of which approximately 60,000 products are maintained in inventory. We strive to carry sufficient inventory to ensure product availability and rapid processing of customer orders. Accurate forecasting of customer demand is essential to establish the proper level of inventory for each product. Inventory levels need to be sufficient to meet customer demand while avoiding the costs of stocking excess items.

During 2011, we purchased products from over 1,000 suppliers and no single supplier accounted for more than five percent of our purchases in 2011. However, the loss of one of our core suppliers could affect our operations by hindering our ability to provide full service to our customers.

We actively participate in the design and development of products with our manufacturers. Technology has helped us to develop new items that are application specific. We review applications and recommend alternative products that may be beneficial to our customers. Our quality control department tests our product offerings to assure they meet our specifications. We also conduct failure analysis and recommend solutions to help customers maximize product performance and avoid costly product failures. To promote brand loyalty, we sell products using various private labels and tradenames including Lawson Products, Kent Automotive, Cronatron, and Drummond, among others.

Sales Force

Our sales force is primarily organized into geographical regions. The performance of each region is the responsibility of a Regional Sales Manager. Each region is further divided into geographically defined districts. The performance of each district is the responsibility of a District Sales Manager who reports to the Regional Sales Manager. Our District Sales Managers concentrate their efforts on driving sales within their district and working with our sales team, composed of approximately 950 independent sales representatives to develop new and existing customers.

Our independent representatives have control over which customers they contact, the frequency of sales calls, the products that are promoted, the prices that are charged and the sales methods that are used. The independent sales representatives are compensated on a variable commission only basis and are responsible for repayment of commissions to the Company on any uncollectible accounts. During the second half of 2011, we implemented a pilot program and hired approximately 40 employee sales representatives. We believe having control over which customers the employee sales representatives contact, the frequency of sales calls, the products that are promoted, the prices that are charged and the sales methods that are used could result in higher productivity. Employee sales representatives receive a fixed salary and are eligible for variable compensation related to sales.

We have also developed a team dedicated to acquiring larger strategic accounts and a team dedicated to serving our governmental accounts. The strategic accounts are comprised of multi-location customers with a national scope. We have assigned some employees to concentrate solely on mid-market account acquisition.

Our sales force receives education in the best uses of our products, enabling them to provide customized solutions to address our customers needs. As part of our Smarter Maintenance proposition, the sales team offers our customers technical expertise and on-site problem resolution. This includes on-site visits to help manage customer inventories, introducing cost saving ideas to improve our customers profitability and regularly analyzing and replenishing inventory to prevent unnecessary purchases and unplanned downtime. The sales force also periodically provides product demonstrations to our customers that are designed to show how our products can improve their productivity. Additionally, we offer customized storage systems to our customers for improved organization and a more efficient workflow.

Employees

Our organization supports a culture of continuous improvement driving results and emphasizes the importance of addressing the needs of our customers. We encourage our employees to be results driven, team oriented, progressive and focused on the future. We require our employees to act with integrity in every aspect of our business.

As of December 31, 2011, our workforce included approximately 950 employees, comprised of approximately 360 in sales and marketing (including approximately 70 District Sales Managers), 440 in operations and distribution and 150 management and administrative staff. Approximately 15% of our workforce is covered by four collective bargaining agreements. We believe that our relations with our employees and their collective bargaining organizations are good.

Non-Core Businesses

Over the past few years, our non-core MRO operations were hit particularly hard by the economic downturn, needed capital investment, had limited opportunity to leverage growth, provided minimal synergistic value and operated at lower margins than the core MRO business. Therefore, we actively evaluated various strategic alternatives regarding these operations.

In 2010, we sold substantially all of the assets of two of our non-core business units, Assembly Component Systems, Inc. and Rutland Tool & Supply Company, Inc. Currently our only non-core operating subsidiary is Automatic Screw Machine Products Company (ASMP). ASMP is based in Decatur, Alabama and distributes components, fasteners, and fittings for use by OEM customers that are specific to their production needs. ASMP accounted for approximately 5% of our net sales for 2011. We will continue to evaluate the strategic options available to us regarding ASMP.

Vision

Our vision is to be our customers first choice for maintenance, repair and operational solutions that improve their operating performance. We plan to achieve our vision by working closely with our customers to maintain and enhance their operations through products, services and innovative solutions.

As part of developing a strategy to support our vision, we conducted extensive customer research to help better understand our customers value drivers and the market in which we currently compete for business, known as our addressable market. We determined that we not only needed to transform our organization to win business from our current addressable market but also to develop the capabilities to expand the size of our addressable market. Therefore, we concentrated on three major initiatives to strengthen our business. Our initiatives were to replace our legacy information systems with a state-of-the-art ERP system, optimize our distribution network and transform our sales channels. Through these initiatives, we aim to deliver an enhanced customer experience, support sales growth and improve operating performance. We have made significant progress in completing each of these initiatives and have further defined the initiatives we will concentrate on to achieve our vision for the future. Our transformation efforts continue to focus on making it easier for our customers to conduct business with us.

ERP

In August 2011, we reached an important milestone as we launched a major phase of our new ERP system. We believe that an integrated ERP system is necessary to support the transformation of our business to better serve our customers and to provide a platform to support growth. The initial implementation included order-to-cash and procure-to-pay processes, warehouse management at three of our distribution centers and our packaging facility as well as our financial reporting system. The ERP system is critical to provide the platform for the launch of our new website, to support the technology requirements of the new distribution center and enable the opportunity to provide enhanced sales solutions in the field. During 2012, we plan to implement the warehouse management system at our future McCook distribution center.

Although we were able to pick, pack and ship orders within hours of going live, we encountered certain challenges which caused delays in our supply chain and fulfillment processes. This led to an increase in backorders and complicated our inventory procurement process. We also experienced higher temporary labor and overtime costs as we worked to address the increase in the number of customer service calls and to reduce backorder levels in a timely manner. Additionally, we encountered certain operating issues that resulted in delays in the collection of our customer receivables. We have seen our backorders continue to decline as our fill rates improve.

We are continuing to resolve various operational issues and make further enhancements to the system as we become more experienced. We believe the new ERP system will provide us reliable, transparent, real-time data access enabling us to make better and faster business decisions leading to more accurate forecasting, shortening order fulfillment time and optimizing our inventory levels. Integration among various functional areas is already improving communication, productivity and efficiency. We believe these improvements will enhance our ability to respond to our customers needs and lead to increased customer satisfaction.

Network Optimization

The goal of our network optimization initiative is to define the optimal number, location, size, and material handling capabilities of our distribution centers to improve customer service, speed of delivery, lower operating expenses and improve working capital investment.

In November 2011, we entered into a lease for a new, state-of-the art packaging and distribution center in McCook, Illinois. This new distribution facility will consolidate operations currently performed in three separate Illinois locations. The new facility is designed to specifically meet our distribution needs and will incorporate upgraded technology and logistics compared to our existing facilities. We expect this new distribution center will be operational by late 2012.

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The consolidation of operations in the new distribution facility is intended to reduce operating expenses being incurred under our current structure. Additional warehouse space provided by the new facility will allow us to support increased sales and together with the improved technology help reduce order processing times and increase order fulfillment rates. The facility s close proximity to a major freight hub will provide us more time to process orders and expand our next-day delivery capability.

In conjunction with closing the Des Plaines, Illinois facility, we will also relocate our corporate headquarters to a leased location in the City of Chicago, approximately three miles from our current headquarters in Des Plaines.

Sales Channel Transformation

Our sales channel transformation initiative concentrates on the following areas:

Sales Management Team Transformation

We believe our sales team transformation can strengthen the quality of customer relationships and improve the consistency of sales execution throughout our organization.

Over the past two years, we have clarified the roles and responsibilities of our sales management team, continually reviewing our territory design and account allocation policies to optimize territory management while maintaining or increasing our customer coverage. We have established a strategic account team dedicated to execute on a market plan to acquire these large strategic accounts. We are also dedicating certain employees to concentrate solely on mid-market account acquisition. Additionally, we are hiring Business Development Managers to identify new business opportunities.

We plan to continue to review and evaluate our sales model to maximize sales and enhance customer satisfaction.

Website Redevelopment

We are committed to the re-development of a fully integrated website that will allow for new and existing customers to easily perform product searches, immediately obtain pricing and place direct orders through the internet. This will also allow the organization to help capture a portion of the unplanned purchases of our customers that often are placed through a website, an opportunity that we do not participate in today. The website will be designed to improve cross-selling and up-selling activity, as well as enhance our visibility to customers when our sales team is not on-site with the customer. We plan to introduce our new website in the second quarter of 2012.

Pricing

We are continuing to develop and implement a market-based, tiered pricing structure that better reflects the value of our products and services to our customers. This market-based approach should promote increasing penetration of our existing customers and attract new accounts at more competitive pricing levels. We are also refining our private label offerings with tiered pricing. The combination of private label and national brands products is designed to better position us to meet the needs of a larger, more diverse customer base and we believe provides a growth opportunity.

Next-Day Delivery

Next-day delivery is an essential requirement identified by our customer research and historically we have lagged behind our competitors in this area. The implementation of ERP and our new state-of-the art distribution facility in McCook, Illinois will enhance our next-day capabilities, allowing us to improve our qualification rate in bid processes and to compete for our customers unplanned spend.

Product Offering

We plan to expand our product portfolio to meet customer demand proactively and increase our ability to qualify and win business in competitive bid processes. The expanded product portfolio should help promote sales to new customers and increase our sales to existing customers. Historically, we have encouraged brand loyalty by selling products using various private labels. Although we will continue to promote private label products, we plan to add more national brands to our product offering to better align our product mix with customer specifications, particularly for larger accounts.

Available Information

We file or furnish annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and file or furnish amendments to those reports pursuant to Section 13(a) or 15(d) of the Exchange Act and Section 16 reports with the Securities and Exchange Commission (SEC). The public can obtain copies of these materials by visiting the SEC s Public Reference Room at 100 F Street, NE, Washington DC 20549 or by accessing the SEC s website at http://www.sec.gov. The public may obtain information on the operation of the SEC s Public Reference Room by calling (800) SEC-0330. In addition, as soon as reasonably practicable after such materials are filed with or furnished to the SEC, we make copies available to the public free of charge through our website at *www.lawsonproducts.com.* Information on our website is not incorporated by reference into this report. We also make available, on our website, the charters of the committees of our Board of Directors, our Code of Business Conduct and our Corporate Governance Principles.

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Executive Officers of the Registrant

The executive officers of Lawson as of January 31, 2012 were as follows.

September 30, Name	September 30, Age	September 30, Year First Elected to Present Office	Position
Thomas J. Neri	60	2007	President, Chief Executive Officer and Director
Harry A. Dochelli	52	2009	Executive Vice President, Chief Operating Officer
Neil E. Jenkins	62	2004	Executive Vice President, Secretary and General Counsel
Robert O. Border	48	2010	Senior Vice President, Chief Information Officer
Stewart A. Howley	50	2008	Senior Vice President, Strategic Business Development
Ronald J. Knutson	48	2009	Senior Vice President, Chief Financial Officer
Michelle I. Russell	50	2012	Senior Vice President, Project Management

Biographical information for the past five years relating to each of our executive officers is set forth below.

Mr. Neri was elected Chief Executive Officer in April 2007 and was elected to the Board of Directors in December 2007. Mr. Neri was elected President and Chief Operating Officer in January 2007 and was elected Executive Vice President, Finance, Planning and Corporate Development; Chief Financial Officer and Treasurer in 2004.

Mr. Dochelli was elected Chief Operating Officer effective December 2009 and served as Executive Vice President, Sales and Marketing from April 2008 to December 2009. Previously, Mr. Dochelli served as Executive Vice President, North America Contract Sales for OfficeMax from 2007 until 2008 and Executive Vice President of U.S. Operations for OfficeMax/Boise Cascade Office Solutions from 2005 to 2007.

Mr. Jenkins was elected Executive Vice President, Secretary and General Counsel in 2004.

Mr. Border was elected Senior Vice President, Chief Information Officer in December 2010 and served as Senior Vice President, Information Technology from September 2009 to December 2010. Previously, Mr. Border served as the Managing Director, Information Technology at Midwest Generation, a subsidiary of Edison Mission Energy, from 2004 until 2009.

Mr. Howley was elected Senior Vice President, Strategic Business Development effective April 2008. Mr. Howley served as Chief Marketing Officer from December 2005 until May 2008.

Mr. Knutson was elected Senior Vice President, Chief Financial Officer effective November 2009. Mr. Knutson served as Senior Vice President, Chief Financial Officer of Frozen Food Express Industries, Inc. from January 2009 to November 2009. Mr. Knutson served as Vice President, Finance of Ace Hardware Corporation from 2006 through 2007.

Ms. Russell was appointed Senior Vice President, Project Management in January 2012. Ms. Russell served as Senior Vice President, Executive Sponsor from March 2010 to January 2012; as Senior Vice President, Operations and Supply Chain Management from August 2007 to March 2010; and as Chief Ethics and Compliance Officer from April 2006 to August 2007.

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ITEM 1A. RISK FACTORS.

In addition to the other information in this Annual Report on Form 10-K for the fiscal year ended December 31, 2011, the following factors should be considered in evaluating Lawson s business. Our operating results depend upon many factors and are subject to various risks and uncertainties. The material risks and uncertainties known to us and described below may negatively affect our business operations or affect our financial results. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations or affect our financial results.

Our results of operations may be adversely impacted by a downturn in the economy.

During 2008 and 2009, we experienced the effects of a severe economic recession in the U.S. and world economies and a tightening of the credit markets. Although the economy has stabilized and improved somewhat in 2010 and 2011, we cannot predict the continued strength of a recovery. Any future economic decline and uncertainty may lead to a further decrease in customer spending and may cause certain customers to cancel or delay placing orders. Some of our customers may file for bankruptcy protection, preventing us from collecting on accounts receivable and may result in our stocking excess customer specific inventory. Continued contraction in the credit markets may also cause some of our customers to experience difficulties in obtaining financing, leading to lower sales, delays in the collection of receivables or result in an increase in bad debt expense.

Adverse economic conditions could also affect our key suppliers, hindering their ability to supply parts and result in delays of our customer shipments. Economic uncertainty can make it difficult for us to accurately predict future order activity and affect our ability to effectively manage inventory levels and identify risks that may affect our business. Our ability to finance our operations by borrowing through our current credit agreement could also be at risk if the lender is unable to provide funds under the terms of the agreement due to a bankruptcy or a restructuring. There are no assurances that we would be able to establish alternative financing or attain financing with terms similar to our present credit agreement.

The market price of our common stock may decline.

Our stock price could decrease if our financial performance is inadequate or does not meet investors expectations, if there is deterioration in the overall market for equities, large amounts of shares are sold in the market or if investors have concerns that our business, financial condition, results of operations and capital requirements are negatively impacted by an economic downturn. A decrease in the price of our stock may reflect a lower market value of our net assets compared to book value, indicating our assets are impaired.

A significant portion of our inventory may become obsolete.

Our business strategy requires us to carry a significant amount of inventory in order to meet rapid processing of customer orders. If our inventory forecasting and production planning processes result in inventory levels exceeding the levels demanded by customers or should our customers decrease their orders with us, our operating results could be adversely affected due to costs of carrying the inventory and additional inventory write-downs for excess and obsolete inventory.

Work stoppages and other disruptions at transportation centers or shipping ports may adversely affect our ability to obtain inventory and make deliveries to our customers.

Our ability to rapidly process customer orders is an integral component of our overall business strategy. Interruptions at our company operated facilities or disruptions at a major transportation center or shipping port, due to events such as severe weather, labor interruptions, natural disasters, acts of terrorism or other events, could affect both our ability to maintain core products in inventory and deliver products to our customers on a timely basis, which may in turn adversely affect our results of operations. We will also face a risk of service disruptions during the transition of our Addison, Des Plaines and Vernon Hills, Illinois operations into the new McCook facility. In addition, severe weather conditions could adversely affect demand for our products.

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Changes in our customers, product mix and pricing strategy could cause our gross margin percentage to decline in the future.

From time to time, we have experienced changes in product mix and inventory costs. When our product mix changes, there can be no assurance that we will be able to maintain our historical gross profit margins. Changes in our customers, product mix, volume of orders or the prices charged could cause our gross profit margin percentage to decline.

Increases in energy costs and the cost of raw materials used in our products could impact our cost of goods and distribution and occupancy expenses, which may result in lower operating margins.

Increases in the cost of raw materials used in our products (e.g., steel) and energy costs raise the production costs of our vendors. Those vendors typically look to pass the higher costs along to us through price increases. If we are unable to fully pass these increased prices and costs through to our customers or to modify our activities, the impact would have an adverse effect on our operating profit margins.

Disruptions of our information and communication systems could adversely affect the Company.

We depend on our information and communication systems to process orders, purchase and manage inventory, maintain cost-effective operations, sell and ship products, manage accounts receivable collections and service our customers. Disruptions in the operation of information and communication systems can occur due to a variety of factors including power outages, hardware failure, programming faults and human error. Any disruption in the operation of our information and communication systems whether over a short or an extended period of time or affecting one or multiple distribution centers could have a material adverse effect on our business, financial condition and results of operations.

The inability of management to successfully implement major strategic initiatives, could result in significant disruptions in the Company s operations and increase our costs.

We have committed to developing and executing three major strategic initiatives to strengthen our core MRO operations which we believe will significantly enhance our ability to better serve our customers and improve our business. The initiatives are expected to transform our current sales channels, optimize our supply network and replace our legacy information systems with an ERP system. In 2011 we completed a major phase of the ERP implementation and we took further steps to transform our sales channels. In 2012, among other undertakings, we plan to continue to implement further phases of our ERP system, transition our Addison, Des Plaines and Vernon Hills, Illinois operations to the new McCook facility, launch a redesigned website and migrate our independent sales representatives to employee sales representatives.

These initiatives involve a large investment of capital and resources and significant changes to our current operating processes. Failure to properly implement one or more of these initiatives could result in disruptions in our operations, loss of business and increased costs.

Failure to manage changes within the organization

We are undergoing significant change including the opening of a new distribution center, relocation of our headquarters, completion of the ERP implementation, launch of a redesigned website and the transition of our independent sales representative model to one that increases productivity and is more market oriented. During the second half of 2011, we implemented a pilot program and hired approximately 40 employee sales representatives. We believe having control over which customers the employee sales representatives contact, the frequency of sales calls, the products that are promoted, the prices that are charged and the sales methods that are used could result in higher productivity. These initiatives, and other changes, could impact our business model and affect the culture of our organization to emphasize continuous improvements, be results driven and focused on our end customer. Failure to manage through these changes could adversely affect our financial position and results of operations.

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Failure to retain talented employees, managers and executives could negatively impact our operating results.

Our success depends on our ability to attract, develop and retain talented employees, including executives and other key managers. The loss of certain key executives and managers, or the failure to attract and develop talented new executives and managers, could have a material adverse effect on our business.

Failure to retain experienced and productive sales representatives could negatively impact our operating results.

Our MRO sales are primarily driven by sales representatives. Failure to attract and retain a sufficient number of talented, experienced and productive sales representatives could have a material adverse effect on our business, financial condition and results of operations.

One stockholder controls the voting rights of approximately 45% of the Company s outstanding shares.

At December 31, 2011, members of the Port family collectively beneficially owned approximately 45% of the outstanding shares of our common stock. In March 2011, in connection with the settlement of litigation between certain members of the Port family, Dr. Port received a proxy to vote the shares held by the members of the Port family until June 2012, other than in connection with votes on mergers and certain other extraordinary corporate transactions. As a result, Dr. Port has sole voting power of approximately 45% of the Company s outstanding shares, which effectively permits him to control stockholder votes concerning the removal and election of directors. The interests of Dr. Port may differ from those of other stockholders.

In addition, in filings with the Securities and Exchange Commission a member of the Port family, controlling approximately a third of the family s interest, has indicated that she intends to sell her shares. Given the low historic trading volume of our common stock, such sales could reduce the market price of our common stock.

The Company operates in highly competitive markets.

Our marketplace, although consolidating, still includes large, fragmented industries which are highly competitive. We believe that customers and competitors may continue to consolidate over the next few years, which may make the industry even more competitive. Our competitors include companies with similar or greater market presence, name recognition, and financial, marketing, and other resources and we believe they will continue to challenge the marketplace with their product selection, financial resources, and services.

Future acquisitions are subject to integration and other risks.

We anticipate that we may, from time to time, selectively acquire additional businesses or assets. Acquisitions are accompanied by risks, such as potential exposure to unknown liabilities of acquired companies and the possible loss of key employees and customers of the acquired business. In addition, we may not obtain the expected benefits or cost savings from acquisitions. Acquisitions are subject to risks associated with financing the acquisition and integrating the operations and personnel of the acquired businesses or assets. If any of these risks materialize, they may result in disruptions to our business and the diversion of management time and attention, which could increase the costs of operating our existing or acquired businesses or negate the expected benefits of the acquisitions.

Failure to meet the covenant requirements of our credit agreement could lead to higher financing costs, increased restrictions and reduce or eliminate our ability to borrow funds.

From time to time we fund our operations from funds borrowed under the terms of our credit agreement. The credit agreement requires us to comply with certain financial covenants, including minimum tangible net worth levels, a minimum cash, accounts receivable and inventory-to-debt ratio, a minimum debt service coverage ratio and minimum quarterly EBITDA levels. The credit agreement also contains other customary representations, warranties, covenants and events of default. Any failure to meet these covenant requirements could lead to higher financing costs, increased restrictions and reduce or eliminate our ability to borrow funds.

Changes that affect governmental and other tax-supported entities could negatively impact our sales and earnings.

A portion of our sales are derived from the United States military and other governmental and tax supported entities. These entities are largely dependent upon government budgets and require adherence to certain laws and regulations. A decrease in the levels of defense and other governmental spending or the introduction of more stringent governmental regulations and oversight could lead to reduced sales or an increase in compliance costs which would adversely affect our financial position and results of operations.

Any violation of Federal, state or local environmental protection regulations could lead to significant penalties and fines.

Our product offering includes a wide variety of industrial chemicals and other products which are subject to a multitude of Federal, state and local regulations. These environmental protection laws change frequently and affect the composition, handling, transportation, storage and disposal of the products. Failure to comply with these regulations could lead to severe penalties and fines for each violation.

Our results of operations could be affected by changes in taxation.

Our results of operations could be affected by changes in tax rates, audits by taxing authorities or changes in laws, regulations and their interpretation. Changes in applicable tax laws and regulations could also affect our ability to realize the deferred tax assets on our balance sheet, which could affect our results of operations.

We are currently the subject of an employment tax examination which could result in a negative settlement.

One of our subsidiaries, Drummond American LLC (Drummond) is under an employment tax examination for the years 2007 and 2008 of the long-standing treatment of its sales representatives as independent contractors. In January 2012 we received a Notice of Proposed Adjustment in the amount of $9.5 million, including penalties, from the IRS challenging Drummond s position that the sales representatives were independent contractors. Although we intend to vigorously defend our position for the treatment of the sales representatives as independent contractors, we established a liability of $1.2 million as our best estimate of the cost to resolve the matter. An unfavorable outcome of this matter could have a material adverse effect on the Company s business, financial condition and results of operation.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

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ITEM 2. PROPERTIES.

In the second half of 2012, we will be consolidating our Midwest distribution operations to a new custom built distribution facility in McCook, Illinois. We also plan to relocate our corporate headquarters to Chicago, Illinois from the current facility in Des Plaines, Illinois. When these relocations have been completed, we will reclassify our Addison, Des Plaines and Vernon Hills, Illinois facilities as Property Held for Sale.

The following owned and leased locations are either currently used in operations or will be used in our operations in 2012:

	September 30,	September 30,	September 30,	September 30,
Location	**Segment**	**Function**	**Own/Lease**	**Square Footage**
Locations to be used				
Chicago, Illinois	MRO	Administration	Lease(1)	86,300
Fairfield, New Jersey	MRO	Distribution	Own	60,000
Independence, Ohio	MRO	Call Center	Lease(2)	9,761
McCook, Illinois	MRO	Packaging/Distribution	Lease(3)	306,805
Mississauga, Ontario Canada	MRO	Distribution	Own	78,000
Reno, Nevada	MRO	Distribution	Own	244,280
Suwanee, Georgia	MRO	Distribution	Own	91,235
Decatur, Alabama	OEM	Manufacturing	Own	65,000
Locations to be disposed				
Addison, Illinois	MRO	Distribution	Own	85,800
Des Plaines, Illinois	MRO	Packaging/Administration	Own	175,000
Des Plaines, Illinois	MRO	Administration	Own	45,000
Des Plaines, Illinois	MRO	Administration	Lease(4)	114,000