LAWSON PRODUCTS INC/NEW/DE/
Form 10-Q
November 05, 2008

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

(Mark One)

þ **Quarterly Report under Section 13 OR 15(d) of the Securities Exchange Act of 1934**
For quarterly period ended September 30, 2008

or

o **Transition Report under 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 its charter)

Delaware	**36-2229304**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1666 East Touhy Avenue, Des Plaines, Illinois	**60018**
(Address of principal executive offices)	(Zip Code)

(847) 827-9666
(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, 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 o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares outstanding of the registrant s common stock, $1 par value, as of October 31, 2008 was 8,522,001.

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Safe Harbor Statement under the Securities Litigation Reform Act of 1995:

This Quarterly Report on Form 10-Q 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 and simi 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 any breach of the terms and conditions of the Deferred Prosecution Agreement with U.S. Attorney s Office for the Northern District of Illinois; excess and obsolete inventory; disruptions of the Company s information systems; risks of rescheduled or cancelled orders; increases in commodity prices; the influence of controlling stockholders; competition and competitive pricing pressures; the effect of general economic conditions and market conditions in the markets and industries the Company serves; the risks of war, terrorism, and similar hostilities; and, all of the factors discussed in the Company s Risk Factors set forth in its Annual Report on Form 10-K for the year ended December 31, 2007 and in this Quarterly Report on Form 10-Q.

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 FINANCIAL INFORMATION
ITEM 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Lawson Products, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets

(Amounts in thousands, except share data)		September 30, 2008 (Unaudited)		December 31, 2007
ASSETS				
Current assets:				
Cash and cash equivalents	$	6,651	$	1,671
Accounts receivable, less allowance for doubtful accounts		56,372		58,882
Inventories		88,806		96,785
Miscellaneous receivables and prepaid expenses		10,032		10,303
Deferred income taxes		5,417		3,226
Discontinued current assets		509		1,064
Total current assets		167,787		171,931
Property, plant and equipment, less accumulated depreciation and amortization		49,481		53,031
Deferred income taxes		19,044		21,344
Goodwill		27,999		27,999
Other assets		23,636		25,558
Total assets	$	287,947	$	299,863
LIABILITIES AND STOCKHOLDERS EQUITY				
Current liabilities:				
Accounts payable	$	21,797	$	16,266
Revolving line of credit		10,500		11,000
Settlement payable current (Note J)		10,000		
Accrued expenses and other liabilities		41,865		45,254
Discontinued current liabilities		87		322
Total current liabilities		84,249		72,842
Accrued liability under security bonus plans		26,311		25,491
Settlement payable noncurrent (Note J)		10,000		
Other		20,767		27,169
		57,078		52,660
Stockholders equity:				

Preferred stock, $1 par value:		
Authorized 500,000 shares, Issued and outstanding None		
Common stock, $1 par value:		
Authorized 35,000,000 shares, Issued and outstanding 8,522,001 shares	8,522	8,522
Capital in excess of par value	4,774	4,774
Retained earnings	133,287	160,606
Accumulated other comprehensive income	37	459
Stockholders equity:	146,620	174,361
Total liabilities and stockholders equity	$ 287,947	$ 299,863

See notes to condensed consolidated financial statements.

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Lawson Products, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations
(Unaudited)

(Amounts in thousands, except per share data)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net sales	$ 124,567	$ 127,913	$ 375,881	$ 386,760
Cost of goods sold	54,275	51,456	159,721	157,779
Gross profit	70,292	76,457	216,160	228,981
Operating expenses:				
Selling, general and administrative expenses	62,994	66,251	192,367	199,714
Settlement and related costs (Note J)	394	1,172	31,562	4,947
Severance and other charges	1,144	3,671	7,659	11,034
Operating income (loss)	5,760	5,363	(15,428)	13,286
Other income	55	160	328	555
Interest expense	(247)	(295)	(690)	(662)
Income (loss) from continuing operations before income taxes	5,568	5,228	(15,790)	13,179
Provision for income taxes	2,500	2,818	5,853	6,063
Income (loss) from continuing operations	3,068	2,410	(21,643)	7,116
Income (loss) from discontinued operations, net of income taxes	10	(11)	(563)	(496)
Net income (loss)	$ 3,078	$ 2,399	$ (22,206)	$ 6,620
Basic income (loss) income per share of common stock:				
Continuing operations	$ 0.36	$ 0.28	$ (2.54)	$ 0.84
Discontinued operations			(0.07)	(0.06)
	$ 0.36	$ 0.28	$ (2.61)	$ 0.78
Diluted income (loss) income per share of common stock:				

Continuing operations	$	0.36	$	0.28	$	(2.54)	$	0.83
Discontinued operations						(0.07)		(0.06)
	$	0.36	$	0.28	$	(2.61)	$	0.78
Cash dividends declared per share of common stock	$	0.20	$	0.20	$	0.60	$	0.60
Weighted average shares outstanding:								
Basic		8,522		8,522		8,522		8,522
Diluted		8,523		8,524		8,522		8,524

See notes to condensed consolidated financial statements.

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Lawson Products, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)

(Amounts in thousands)	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Operating activities:		
Net (loss) income	$ (22,206)	$ 6,620
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	6,474	6,003
Provision for settlement	30,000	
Settlement payment	(10,000)	
Changes in operating assets and liabilities	14,951	(10,117)
Other	(6,261)	1,610
Net cash provided by operating activities	12,958	4,116
Investing activities:		
Additions to property, plant and equipment	(2,736)	(13,805)
Net cash used for investing activities	(2,736)	(13,805)
Financing activities:		
Net (payments) proceeds from revolving line of credit	(500)	13,000
Dividends paid	(5,113)	(5,113)
Other		27
Net cash (used for) provided by financing activities	(5,613)	7,914
Increase (decrease) in cash and cash equivalents	4,609	(1,775)
Cash and cash equivalents at beginning of period	2,473	4,320
Cash and cash equivalents at end of period	7,082	2,545
Cash held by discontinued operations	(431)	(881)
Cash and cash equivalents held by continuing operations at end of period	$ 6,651	$ 1,664

See notes to condensed consolidated financial statements.

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Lawson Products, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
(Dollars in Thousands, except per share data)

Note A Basis of Presentation and Summary of Significant Accounting Policies

The accompanying condensed consolidated financial statements of Lawson Products, Inc. (the Company) have been prepared in accordance with generally accepted accounting principles for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not contain all disclosures required by generally accepted accounting principles. Reference should be made to the Company s Annual Report on Form 10-K for the year ended December 31, 2007. The Condensed Consolidated Balance Sheet as of September 30, 2008, the Condensed Consolidated Statements of Operations for the three-month and nine-month periods ended September 30, 2008 and 2007 and the Condensed Consolidated Statements of Cash Flows for the nine-month periods ended September 30, 2008 and 2007 are unaudited. In the opinion of the Company, all adjustments (consisting only of normal recurring accruals) have been made, that are necessary to present fairly the results of operations for the interim periods. Operating results for the three and nine-month period ended September 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

There have been no material changes in our significant accounting policies during the nine months ended September 30, 2008 as compared to the significant accounting policies described in our Annual Report on Form 10-K for the year ended December 31, 2007.

Certain severance and settlement costs have been reclassified from selling, general and administrative expenses to separate line items within the Condensed Consolidated Statements of Operations.

Note B Comprehensive Income (loss)

Components of comprehensive income (loss) for the three and nine months ended September 30, 2008 and 2007 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income (loss)	$ 3,078	$ 2,399	$ (22,206)	$ 6,620
Foreign currency translation adjustment	(310)	466	(422)	922
Comprehensive income (loss)	$ 2,768	$ 2,865	$ (22,628)	$ 7,542

Note C Earnings Per Share

The calculations of dilutive weighted average shares outstanding for the three and nine months ended September 30, 2008 and 2007 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Basic weighted average shares outstanding	8,522	8,522	8,522	8,522
Dilutive impact of stock options outstanding	1	2		2
Dilutive weighted average shares outstanding	8,523	8,524	8,522	8,524

Stock options for the nine months ended September 30, 2008, would have been anti-dilutive and therefore were excluded from the computation of diluted earnings per share.

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Note D Revolving Line of Credit

The revolving line of credit has a maximum borrowing capacity of $75 million and a maturity date of March 27, 2009. The revolving line of credit carries a floating interest rate of prime minus 1.5% or LIBOR plus 0.75%, at the Company s option. Interest is payable quarterly on prime rate borrowings and at contract expirations for LIBOR borrowings. The Company had $10.5 million of borrowings under the line of credit with an effective interest rate of 3.5% at September 30, 2008.

The line of credit contains certain financial covenants regarding interest coverage, minimum stockholders equity and working capital. The revolving credit agreement was amended in the third quarter of 2008 to modify certain covenant calculations relating to the $30,000 provision made in connection with the settlement of the investigation by the U.S. Attorney s Office (see Note J). The Company was in compliance with all covenants at September 30, 2008.

Note E Severance and Other Charges

Components of severance and other charges for the three and nine months ended September 30, 2008 and 2007 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Severance	$ 809	$ 3,671	$ 3,724	$ 11,034
Unclaimed Property	335		3,935	
Total Severance and Other Charges	$ 1,144	$ 3,671	$ 7,659	$ 11,034

Unclaimed property charges relate primarily to years prior to 2003.

The table below shows the changes in the Company s reserves for severance and related payments, included in accrued expenses and other liabilities on the balance sheet as of September 30, 2008 and 2007:

	2008	2007
Balance at beginning of year	$ 7,058	$ 962
Charged to earnings	3,724	11,034
Cash paid	(4,655)	(3,924)
Adjustment to reserves	(42)	(120)
Balance at September 30	$ 6,085	$ 7,952

Note F Intangible Assets

Intangible assets subject to amortization, included within other assets, were as follows on September 30, 2008 and December 31, 2007:

	September 30, 2008			December 31, 2007		
	Gross Balance	Accumulated Amortization	Net Carrying Amount	Gross Balance	Accumulated Amortization	Net Carrying Amount
Trademarks and tradenames	$ 1,400	$ 775	$ 625	$ 1,400	$ 737	$ 663
Non-compete covenant	1,000	550	450	1,000	400	600
	$ 2,400	$ 1,325	$ 1,075	$ 2,400	$ 1,137	$ 1,263

Trademarks and tradenames are amortized over 20 years. The non-compete covenant associated with the 2005 acquisition of Rutland is being amortized over 5 years. Amortization expense, all of which is included in the MRO distribution segment, for these intangible assets is expected to be $250 per year for 2008, 2009 and 2010 and $50 per year thereafter until the trademarks and tradenames are fully amortized.

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Note G Stock-Based Compensation

The Stock Performance Plan (the Plan) provides for the issuance of incentive compensation to non-employee directors, officers and key employees in the form of stock performance rights (SPRs).

Stock Performance Rights

SPRs vest at 20 percent or 33 percent per year and entitle the recipient to receive a cash payment equal to the excess of the market value of the Company s common stock over the SPR exercise price when the SPRs are surrendered. The Company estimates the fair value of SPRs using the Black-Scholes valuation model each quarter. This model requires the input of subjective assumptions that will usually have a significant impact on the fair value estimate. The weighted-average estimated fair value of SPRs outstanding at September 30, 2008 was $5.54 per SPR with the following assumptions:

Expected volatility	30.9% to 44.0%
Risk-free interest rate	1.8% to 3.1%
Expected term (in years)	1.1 to 5.6
Expected dividend yield	2.9%

Compensation expense of $71 and a benefit of $860 was recorded for outstanding SPRs in selling, general and administrative expenses in the third quarters of 2008 and 2007, respectively. Compensation income of $1,060 and $1,035 was recorded for outstanding SPRs in the first nine months of 2008 and 2007, respectively.

Activity related to the Company s SPRs during the first three quarters of 2008 was as follows:

	Number of SPRs	Average SPR Exercise Price
Outstanding on December 31, 2007	209,250	$ 34.17
Granted	151,500	25.82
Exercised	(28,250)	27.14
Forfeited	(24,100)	25.53
Outstanding on September 30, 2008	308,400	$ 31.39
Exercisable on September 30, 2008	140,067	$ 34.38

The aggregate intrinsic value of SPRs outstanding was $266 as of September 30, 2008.

As of September 30, 2008, there was $684 of unrecognized compensation cost related to non-vested SPRs, which will be recognized over a weighted average period of 1.7 years.

Stock Options

There were no stock options granted, exercised or cancelled in the first nine months of 2008. As of September 30, 2008, the Company had 5,000 outstanding stock options at a weighted average exercise price of $23.11 and a weighted average remaining life of 1.3 years.

As of December 31, 2007, all outstanding stock options were fully vested, and no remaining unrecognized compensation expense is to be recorded in 2008.

Note H Segment Reporting

The Company has two reportable segments: Maintenance, Repair and Operations distribution in North America (MRO), and Original Equipment Manufacturer distribution and manufacturing in North America

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(OEM). The Company s reportable segments are distinguished by the nature of products, types of customers, and manner of servicing customers.

The Company s MRO distribution segment supplies a wide range of MRO parts to repair and maintenance organizations primarily through the Company s force of independent field sales agents, as well as inside sales personnel.

The Company s OEM segment manufactures and distributes component parts to OEM manufacturers through a network of independent manufacturers representatives as well as internal sales personnel.

The Company evaluates performance and allocates resources to reportable segments primarily based on operating income.

The following table presents summary financial information for the Company s reportable segments:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net sales				
MRO	$ 102,692	$ 108,183	$ 312,011	$ 323,344
OEM	21,875	19,730	63,870	63,416
Consolidated total	$ 124,567	$ 127,913	$ 375,881	$ 386,760
Operating income (loss)				
MRO	$ 8,547	$ 5,065	$ (13,425)	$ 10,263
OEM	(2,787)	298	(2,003)	3,023
Consolidated total	$ 5,760	$ 5,363	$ (15,428)	$ 13,286
Investment and other income	55	160	328	555
Interest expense	(247)	(295)	(690)	(662)
Income (loss) from continuing operations before income taxes	$ 5,568	$ 5,228	$ (15,790)	$ 13,179

Asset information for continuing operations related to the Company s reportable segments consisted of the following:

	September 30, 2008	December 31, 2007
Total assets		
MRO	$ 211,523	$ 221,274
OEM	51,454	52,995
Segment total	262,977	274,229
Corporate	24,461	24,570

Consolidated total	$ 287,438	$ 298,799

At September 30, 2008 and December 31, 2007, the carrying value of goodwill within each reportable segment was as follows:

MRO	$ 25,748
OEM	2,251
Consolidated total	$ 27,999

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Note I Income Tax Expense

The income tax provision recorded for the nine months ended September 30, 2008 of $5,853 was affected by approximately $29,200 of the $30,000 provision related to the settlement of the investigation by the U.S. Attorney s Office for the Northern District of Illinois, which was non-deductible. Excluding the effect of the non-deductible settlement, the income tax as a percentage of pre-tax income for the nine months ended September 30, 2008 was 43.6% compared to 46.0% for the nine months ended September 30, 2007. Income tax as a percentage of pre-tax income for the third quarter of 2008 was 44.9% compared to 53.9% for the third quarter of 2007. The higher rate for 2007 was related to the exclusion of tax deductions for expenses related to the Company s customer loyalty programs.

At September 30, 2008, the Company had $923 in unrecognized tax benefits, the recognition of which would have a favorable effect on the effective tax rate. Due to the uncertainty of both timing and resolution of income tax examinations, the Company is unable to determine whether any amounts included in the September 30, 2008 balance of unrecognized tax benefits represent tax positions that could significantly change during the next twelve months.

The Company s continuing practice is to recognize interest and penalties related to unrecognized tax benefits in income tax expense. The Company had $1,529 accrued for interest and penalties at September 2008.

The Company and its subsidiaries are subject to U.S Federal income tax as well as income tax of multiple state and international jurisdictions. As of September 30, 2008, the Company is subject to U.S. Federal income tax examinations for the years 2000 through 2007 and to non-U.S. income tax examinations for the tax years of 2000 through 2007. In addition, the Company is subject to state and local income tax examinations for the tax years 2000 through 2007.

Note J Legal Proceedings

In December 2005, the FBI executed a search warrant for records at the Company s offices and informed the Company that it was conducting an investigation as to whether any of the Company s representatives improperly provided gifts or awards to purchasing agents (including government purchasing agents) through the Company s customer loyalty programs (the investigation). The U.S. Attorney s Office for the Northern District of Illinois (the U.S. Attorney s Office) subsequently issued a subpoena for documents in connection with the investigation.

In April 2007, thirteen people, including seven former sales agents of the Company, were indicted on federal criminal charges, including mail fraud, in connection with the investigation. These indictments alleged that, under the Company s customer loyalty programs, sales agents would provide cash gift certificates to individuals purchasing Company merchandise on behalf of their employers as a way to increase their commissions and prices paid by customers. All of the cases involved commissioned sales agents of the Company. All seven of the indicted former sales agents have entered guilty pleas to federal criminal charges.

On August 11, 2008, in connection with the investigation, the Company entered into a Deferred Prosecution Agreement (the DPA) with the U.S. Attorney s Office. An additional three people, including a former sales manager and a former sales agent were indicted on August 11, 2008 and have since pled guilty. Under the terms of the DPA, the U.S. Attorney s Office filed a one-count criminal Information charging the Company with mail fraud in the U.S. District Court for the Northern District of Illinois, but will defer prosecution of such charge for three years. If the Company abides by the terms and conditions of the DPA, the U.S. Attorney s Office will seek dismissal with prejudice of the Information within 30 days of the expiration of the three-year period.

Pursuant to the DPA, the Company agreed to a $30,000 penalty, which includes $806 of restitution, and recorded a charge of $30,000 in the second quarter of 2008. The penalty is payable in three equal installments. The first $10,000 payment was made in August 2008. The second $10,000 payment is due

August 2009, and the final $10,000 payment is due August 2010. If a controlling interest in the Company is sold, any unpaid amounts shall be accelerated and due at the closing of the sale.

Under the DPA, the Company agreed to make restitution payments to those customers that employed individuals who received over $10 in payments through the Winners Choice incentive program, or that employed individuals who have been or later are convicted of mail fraud as a result of Winners Choice payments, or that purchased Company merchandise from sales agents who have been or later are convicted of mail fraud for providing checks to the customer s employees. Restitution payments made to these customers will be paid from the Company s first installment payment.

In conjunction with the Company s internal investigation, several customer loyalty programs were terminated because the Company believes that these programs provided or had the potential of providing promotional considerations, such as gifts and awards, to purchasing agents that the Company has deemed inappropriate. The Company has modified another customer loyalty program to limit the amount and nature of customer gifts distributed under the program. In addition, twenty-three independent agents have been terminated, a number have resigned and the Company has terminated four employees. The Company has also implemented a compliance and ethics program to prevent future abuses. Under the terms of the DPA, the Company agreed to continue to implement its compliance and ethics program.

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Lawson Products, Inc.

We have reviewed the condensed consolidated balance sheet of Lawson Products, Inc. and subsidiaries as of September 30, 2008 and the related condensed consolidated statements of operations for the three and nine month periods ended September 30, 2008 and 2007 and the related condensed consolidated statements of cash flows for the nine month periods ended September 30, 2008 and 2007. These financial statements are the responsibility of the Company s management.

We conducted our review in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the condensed consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Lawson Products, Inc. and subsidiaries as of December 31, 2007, and the related consolidated statements of income, changes in stockholders equity and cash flows for the year then ended, not presented herein, and in our report dated March 10, 2008, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2007, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

ERNST & YOUNG LLP
Chicago, Illinois
November 4, 2008

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Quarter ended September 30, 2008 compared to Quarter ended September 30, 2007

The following table presents a summary of the Company s financial performance for the third quarters of 2008 and 2007:

	2008		2007	
	Amount	% of Net Sales	Amount	% of Net Sales
Net sales				
MRO	$ 102,692	82.4%	$ 108,183	84.6%
OEM	21,875	17.6	19,730	15.4
Consolidated total	$ 124,567	100.0	$ 127,913	100.0
Gross profit				
MRO	$ 68,833	67.0%	$ 72,154	66.7%
OEM	1,459	6.7	4,302	21.8
Consolidated total	70,292	56.4	76,456	59.8
Operating expenses:				
Selling, general and administrative expenses	62,994	50.6	66,251	51.8
Settlement related costs	394	0.3	1,172	0.9
Severance and other charges	1,144	0.9	3,671	2.9
Operating income	5,760	4.6	5,363	4.2
Other, net	(192)	(0.1)	(135)	(0.1)
Income from continuing operations before income tax expense	5,568	4.5	5,228	4.1
Income tax expense	2,500	2.0	2,818	2.2
Income from continuing operations	$ 3,068	2.5%	$ 2,410	1.9%

Net Sales

Net sales for the three-month period ended September 30, 2008 decreased 2.6% to $124.6 million, from $127.9 million in the same period of 2007.

MRO net sales decreased $5.5 million or 5.1% in the third quarter of 2008, to $102.7 million from $108.2 million in the prior year period. MRO net sales declined primarily as a result of lower sales in metal working products and chemicals which were negatively impacted by a net reduction of approximately 100 sales agents from September 30, 2007 to September 30, 2008.

OEM net sales increased $2.2 million in the third quarter of 2008, to $21.9 million from $19.7 million in the prior year period. The sales increase experienced during the third quarter was primarily attributable to expanding the volume of sales generated from our current customers.

Gross Profit

The gross profit margin for the third quarter of 2008 was 56.4%, 3.4 percentage points lower than the 59.8% achieved in the third quarter of 2007. The decline in gross profit margin is primarily attributable to a change in sales mix and increased product and commodity costs.

MRO gross profit decreased $3.3 million or 4.6% in the third quarter of 2008, to $68.8 million from $72.2 million in the prior year period. However, gross profit as a percent of net sales increased slightly to 67.0% for the third quarter of 2008 from 66.7% in the third quarter of 2007. The 2008 gross margin includes a $2.4 million favorable inventory reserve adjustment. Excluding the inventory adjustment, gross profit as a percent of net sales declined to 64.7% for the third quarter of 2008, reflecting increased product and commodity costs. Additional price increases will be implemented in the fourth quarter period to offset these increased costs.

OEM gross profit decreased $2.8 million in the third quarter of 2008, to $1.5 million from $4.3 million in the prior year period. The decrease was primarily due to a $2.7 million inventory reserve adjustment and increased product and commodity costs. Price increases to cover the increased product and commodity costs have not yet been fully implemented due to existing contractual obligations. Excluding the inventory adjustment, gross profit as a percent of net sales decreased to 18.8% for the third quarter of 2008 from 21.8% in the third quarter of 2007

Selling, General and Administrative Expenses (SG&A)

SG&A expenses were $63.0 million and 50.6% of net sales and $66.3 million and 51.8% of net sales for the quarters ended September 30, 2008 and 2007, respectively. The $3.3 million reduction in third quarter 2008 SG&A expenses primarily reflects lower sales commission and employee compensation costs.

Settlement Related Costs

The Company incurred costs of $0.4 million and $1.2 million in the third quarter of 2008 and 2007, respectively, related to the investigation by the U.S. Attorney s Office for the Northern District of Illinois as to whether Company sales representatives provided improper gifts or awards to purchasing agents (including government purchasing agents) through the Company s customer loyalty programs. See Note J in the Condensed Consolidated Financial Statements for further information.

Severance and Other Charges

In the third quarter of 2008, the Company recorded $1.1 million of severance and other charges. Of this amount, $0.8 million related to severance costs associated with the departure of certain executives and operational efficiency improvement initiatives implemented in 2008 and $0.3 million related to unclaimed property liabilities relating primarily to years prior to 2003. In the third quarter of 2007, the Company recorded $3.7 million of severance costs.

Income Tax Expense

For the three months ended September 30, 2008, the Company recorded $2.5 million of income tax expense, based on a pre-tax income from continuing operations of $5.6 million, resulting in an effective tax rate of 44.9%. For the three months ended September 30, 2007, income tax expense of $2.8 million was recorded based on pre-tax income of $5.2 million, resulting in an effective tax rate of 53.9%. The higher rate for 2007 was related to the exclusion of tax deductions for expenses related to the Company s customer loyalty programs.

Nine Months ended September 30, 2008 compared to Nine Months ended September 30, 2007

The following table presents a summary of the Company s financial performance for the nine months ended September 30, 2008 and 2007:

	2008		2007	
	Amount	% of Net Sales	Amount	% of Net Sales
Net sales				
MRO	$ 312,011	83.0%	$ 323,344	83.6%
OEM	63,870	17.0	63,416	16.4
Consolidated total	$ 375,881	100.0	$ 386,760	100.0
Gross profit				
MRO	$ 205,836	66.0%	$ 214,216	66.3%
OEM	10,324	16.2	14,764	23.3
Consolidated total	216,160	57.5	228,980	59.2
Operating expenses:				
Selling, general and administrative expenses	192,367	51.2	199,714	51.6
Settlement and related costs	31,562	8.4	4,947	1.3
Severance and other charges	7,659	2.0	11,034	2.9
Operating (loss) income	(15,428)	(4.1)	13,286	3.4
Other, net	(362)	(0.1)	(107)	
(Loss) income from continuing operations before income tax expense	(15,790)	(4.2)	13,179	3.4
Income tax expense	5,853	1.6	6,063	1.6
(Loss) income from continuing operations	$ (21,643)	5.8%	$ 7,116	1.8%

Net Sales

Net sales for the nine-month period ended September 30, 2008 decreased 2.8% to $375.9 million, from $386.8 million in the same period of 2007.

MRO net sales decreased $11.3 million or 3.5% in the first nine months of 2008, to $312.0 million from $323.4 million in the prior year period. MRO net sales declined primarily as a result of lower sales in metal working products and chemicals which were negatively impacted by a net reduction of approximately 100 sales agents from September 30, 2007 to September 30, 2008.

OEM net sales increased $0.5 million in the first nine months of 2008, to $63.9 million from $63.4 million in the prior year period. The sales increase was primarily attributable to expanding the volume of sales generated from our current customers partially offset by customer losses.

Gross Profit

Gross profit margins for the first nine months of 2008 were 57.5% down 1.7 percentage points from 59.2% in the first nine months of 2007. The decline in gross profit margin is primarily attributable to a change in sales mix and increased product and commodity costs.

MRO gross profit decreased $8.4 million or 3.9% in the first nine months of 2008, to $205.8 million from $214.2 million in the prior year period. Gross profit as a percent of net sales decreased slightly to 66.0% for the first nine months of 2008 from 66.3% in the prior year period. Excluding a favorable $2.4 million inventory reserve adjustment, gross profit as a percent of net sales was 65.2% for the 2008 period.

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OEM gross profit decreased $4.5 million in the first nine months of 2008, to $10.3 million from $14.8 million in the prior year period. The decrease was partially due to a $2.7 million inventory reserve adjustment and increased product and commodity costs. Excluding the inventory adjustment, gross profit as a percent of net sales decreased to 20.3% for the first nine months of 2008 from 23.3% in the first nine months of 2007 reflecting increased product and commodity costs.

Selling, General and Administrative Expenses

SG&A expenses were $192.4 million and 51.2% of net sales and $199.7 million and 51.6% of net sales for the nine-months ended September 30, 2008 and 2007, respectively. The $7.3 million reduction in SG&A expenses reflects lower sales commission and employee compensation costs, offset partially by higher supplies expense and consulting fees.

Settlement and *Related Costs*

The Company incurred penalties and related costs of $31.6 million in the first nine-months of 2008 and investigation costs of $4.9 million in the first nine-months of 2007 in conjunction with the investigation by the U.S. Attorney s Office for the Northern District of Illinois related to whether Company sales representatives provided improper gifts or awards to purchasing agents (including government purchasing agents) through the Company s customer loyalty programs. See Note J in the Condensed Consolidated Financial Statements for further information.

Severance and Other Charges

In the first nine-months of 2008, the Company recorded $7.6 million of severance and other charges. Of this amount, $3.7 million related to severance costs associated with the departure of certain executives and operational efficiency improvement initiatives implemented in 2008 and $3.9 million related to unclaimed property liabilities relating primarily to years prior to 2003. In the first nine-months of 2007, the Company recorded $11.0 million of severance and other charges.

Income Tax Expense

The income tax provision recorded for the nine months ended September 30, 2008 of $5.9 million was affected by approximately $29.2 million of the $30 million provision related to the settlement of the investigation by the U.S. Attorney s Office for the Northern District of Illinois, which was non-deductible. Excluding the effect of the non-deductible settlement, the income tax as a percentage of pre-tax income for the nine months ended September 30, 2008 was 43.6% compared to 46.0% for the nine months ended September 30, 2007.

Liquidity and Capital Resources

Net cash provided by operations was $13.0 million for the first nine months of 2008 compared to $4.1 million in the first nine months of 2007. The $8.9 million increase is primarily due to improved working capital utilization.

Working capital, including cash and cash equivalents, at September 30, 2008, was $83.5 million as compared to $99.1 million at December 31, 2007. The $15.6 million decrease in working capital is primarily attributable to the $10.0 million current liability relating to settlement of the investigation by the U.S. Attorney s Office for the Northern District of Illinois and an $8.0 million reduction in inventory resulting from initiatives taken to improve the inventory management process.

Net cash used for investing activities was $2.7 million for the nine-month period ended September 30, 2008 compared to $13.8 million for the prior year period, reflecting lower capital expenditures in the first nine months of 2008. Capital expenditures in 2008 were principally related to improvement of existing facilities and the purchase of related equipment. For the 2007 period, capital expenditures were principally related to the Reno, Nevada facility expansion, which was completed in 2007.

Net cash used in financing activities in the first nine months of 2008 was $5.6 million compared to net cash provided by financing activities of $7.9 million in the first nine months of 2007, primarily reflecting borrowings and payments on the Company s revolving line of credit.

The Company announced a cash dividend of $.20 per common share in the third quarter of 2008, equal to the cash dividend of $.20 per share announced in the third quarter of 2007.

Cash from operations and a $75.0 million unsecured revolving line of credit have been sufficient to fund operating requirements, cash dividends and capital expenditures. The Company had $10.5 million outstanding as of September 30, 2008 under its revolving line of credit. The line of credit contains certain financial covenants regarding interest coverage, minimum stockholders equity and working capital. The revolving credit agreement was amended in the third quarter of 2008, to modify certain covenant calculations relating to the $30 million provision made in connection with the settlement of the investigation by the U.S. Attorney s Office. The Company was in compliance with all covenants at September 30, 2008.

Cash from operations and the revolving line of credit are expected to be adequate to finance the Company s future operations including the remaining settlement payments and costs related to the investigation with the U.S. Attorney s Office. However, if market and other conditions change from those we anticipate due to a prolonged economic slowdown, our liquidity may be adversely affected.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market risk at September 30, 2008 from that reported in the Company s Annual Report on Form 10-K for the year ended December 31, 2007.

ITEM 4. CONTROLS AND PROCEDURES

The Company s Chief Executive Officer and Chief Financial Officer have concluded, based on their evaluation as of the end of the period covered by this report, that the Company s disclosure controls and procedures (as defined in the Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) are effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding financial disclosures.

There was no change in the Company s internal control over financial reporting that occurred during the quarter ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II
OTHER INFORMATION

ITEMS 2, 3, 4 and 5 of Part II are inapplicable and have been omitted from this report.

ITEM 1. LEGAL PROCEEDINGS

The information under Note J to the Condensed Consolidated Financial Statements is incorporated herein by reference. The description of the DPA is qualified in its entirety by the actual agreement, which is filed as Exhibit 10.1 with the Company s Form 10-Q for the quarter ended June 30, 2008 and was incorporated herein by reference.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2007, except as described below. The description of these material changes does not represent a comprehensive list of risk factors that could cause our results to differ from those that are currently anticipated and, therefore, should be read in conjunction with the risk factors and other information disclosed in our Annual Report.

The signing of a Deferred Prosecution Agreement with the U.S. Attorney s Office for the Northern District of Illinois, and any potential breach of such agreement, may adversely affect our business, financial condition, results of operations and stock price.

We have entered into a Deferred Prosecution Agreement (the DPA) with the U.S. Attorney s Office for the Northern District of Illinois (the U.S. Attorney s Office), which provides for the payment of $30,000,000 in penalties to resolve our liability for the actions of our representatives in improperly providing gifts or awards to purchasing agents through our then-existing customer loyalty programs. The DPA may impact our balance sheet and our ability to borrow funds to pay the penalty. The signing of the DPA may also negatively affect our ability to do business with certain customers (both government and non-government customers). We cannot predict the impact, if any, of the signing of the DPA on our business, financial condition, results of operations, and stock price.

In addition, under the terms of the DPA, if it is determined that we deliberately gave false, incomplete or misleading information under the DPA or have committed any federal crimes subsequent to the DPA, or otherwise knowingly, intentionally, and materially violated any provision of the DPA, we may be subject to prosecution for any federal criminal violation of which the U.S. Attorney s Office has knowledge. For more information on the DPA, see Note J to the Condensed Consolidated Financial Statements included in this Form 10-Q.

Our results of operations may be adversely impacted by a worldwide macroeconomic downturn. As a result, the market price of our common stock may decline.

In 2008, general worldwide economic conditions have experienced a downturn due to the sequential effects of the subprime lending crisis, general credit market crisis, collateral effects on the finance and banking industries, increased commodity costs, volatile energy costs, concerns about inflation, slower economic activity, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns. These conditions make it difficult for our customers and us to accurately forecast and plan future business activities, and they could cause U.S. and foreign businesses to slow spending on our products, which would adversely impact our revenues and our ability to manage inventory levels, collect customer receivables and ultimately our profitability. We cannot predict the timing or duration of any economic slowdown or the timing or strength of a subsequent economic recovery. Additionally, our stock price could decrease if investors have concerns that our business, financial condition and results of operations will be negatively impacted by a worldwide macroeconomic downturn.

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ITEM 6. EXHIBITS

Exhibit #

15	Letter from Ernst & Young LLP Regarding Unaudited Interim Financial Information
31.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

LAWSON PRODUCTS, INC.
(Registrant)

Dated November 5, 2008	/s/ Thomas J. Neri Thomas J. Neri Chief Executive Officer
Dated November 5, 2008	/s/ F. Terrence Blanchard F. Terrence Blanchard Chief Financial Officer