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ROYAL APPLIANCE MANUFACTURING CO
Form 10-Q
May 08, 2001

1

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934. For the quarterly period ended MARCH 31, 2001.
- 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 0-19431

ROYAL APPLIANCE MFG. CO.

(Exact name of registrant as specified in its charter)

OHIO

34-1350353

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification Number)

7005 COCHRAN ROAD, GLENWILLOW, OHIO

44139

(Address of Principal Executive Offices)

Zip Code

(440) 996-2000

(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 shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No .
--- ---

Indicate the number of shares outstanding of each of the issuer's classes of common shares, as of the latest practicable date.

Common Shares, without par value

13,834,452

(Class)

(Outstanding at May 4, 2001)

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The Exhibit index appears on sequential page 16.

2
1

ROYAL APPLIANCE MFG. CO. AND SUBSIDIARIES

INDEX

	Page Number -----
Part I	
	FINANCIAL INFORMATION
Item 1	
-----	-----
	Financial Statements
	Consolidated Balance Sheets - March 31, 2001 and December 31, 2000
	3
	Consolidated Statements of Operations - three months ended March 31, 2001 and 2000
	4
	Consolidated Statements of Cash Flows - three months ended March 31, 2001 and 2000
	5
	Notes to Consolidated Financial Statements
	6 - 9
Item 2	
-----	-----
	Management's Discussion and Analysis of Financial Condition and Results of Operations
	10 - 13
Part II	
	OTHER INFORMATION
Item 6	
-----	-----
	Exhibits and Reports on Form 8-K
	14
Signatures	15
Exhibit Index	16
	*Numbered in accordance with Item 601 of Regulation S-K

3
2

Part I - FINANCIAL INFORMATION
Item 1 - FINANCIAL STATEMENTS

ROYAL APPLIANCE MFG. CO. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

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(Dollars in thousands)

	March 31, 2001	December 31, 2000
	-----	-----
ASSETS	(Unaudited)	
Current assets:		
Cash	\$ 1,104	\$ 704
Trade accounts receivable, net	42,581	42,097
Inventories	36,403	45,470
Deferred income taxes	4,125	4,735
Prepaid expenses and other	1,718	1,573
	-----	-----
Total current assets	85,931	94,579
	-----	-----
Property, plant and equipment, at cost:		
Land	1,541	1,541
Building	7,777	7,777
Molds, tooling, and equipment	48,755	48,650
Furniture, office and computer equipment and software	13,416	12,721
Assets under capital leases	3,171	3,171
Leasehold improvements and other	5,249	5,067
	-----	-----
	79,909	78,927
Less accumulated depreciation and amortization	(40,611)	(37,119)
	-----	-----
	39,298	41,808
	-----	-----
Tooling deposits	1,811	807
Other	3,267	1,358
	-----	-----
Total assets	\$ 130,307	\$ 138,552
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Trade accounts payable	\$ 26,154	\$ 22,209
Accrued liabilities:		
Advertising and promotion	8,685	13,103
Salaries, benefits, and payroll taxes	4,321	3,355
Warranty and customer returns	9,900	9,800
Income taxes	1,572	-
Other	6,727	6,091
Current portions of capital lease obligations and notes payable	138	136
	-----	-----
Total current liabilities	57,497	54,694
	-----	-----
Revolving credit facility	33,550	46,400
Capitalized lease obligations, less current portion	2,103	2,137
	-----	-----
Total long-term debt	35,653	48,537
Deferred income taxes	3,793	4,268
	-----	-----
Total liabilities	96,943	107,499
	-----	-----
Commitments and contingencies (Note 4)	-	-

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Shareholders' equity:		
Common shares, at stated value	212	212
Additional paid-in capital	43,175	43,038
Retained earnings	63,339	61,165
	-----	-----
	106,726	104,415
Less treasury shares, at cost (11,780,500 shares at March 31, 2001 and December 31, 2000)	(73,362)	(73,362)
	-----	-----
Total shareholders' equity	33,364	31,053
	-----	-----
Total liabilities and shareholders' equity	\$ 130,307	\$ 138,552
	=====	=====

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

3

4

Part I - FINANCIAL INFORMATION
Item 1 - FINANCIAL STATEMENTS

ROYAL APPLIANCE MFG. CO. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(Dollars in thousands, except per share amounts)

	Three Months Ended March 31,	
	2001	2000
	-----	-----
Net sales	\$104,522	\$103,470
Cost of sales	81,888	80,015
	-----	-----
Gross margin	22,634	23,455
Advertising and promotion	8,639	11,990
Other selling	2,480	1,978
General and administrative	4,976	4,886
Engineering and product development	1,914	1,750
	-----	-----
Income from operations	4,625	2,851
Interest expense, net	739	674
Receivable securitization and other expense, net	515	470
	-----	-----
Income before income taxes	3,371	1,707
Income tax expense	1,197	627
	-----	-----
Net income	\$ 2,174	\$ 1,080

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	=====	=====
BASIC		
Weighted average number of common shares outstanding (in thousands)	13,729	16,471
Earnings per share	\$.16	\$.07
DILUTED		
Weighted average number of common shares and equivalents outstanding (in thousands)	14,231	16,717
Earnings per share	\$.15	\$.06

The accompanying notes are an integral part of these financial statements

4

5

Part I - FINANCIAL INFORMATION
Item 1 - FINANCIAL STATEMENTS

ROYAL APPLIANCE MFG. CO. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Dollars in thousands)

	Three Months Ended March 31,	
	2001	2000
	-----	-----
Cash flows from operating activities:		
Net income	\$ 2,174	\$ 1,080
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	3,613	3,331
Compensatory effect of stock awards	137	107
Deferred income taxes	(177)	(87)
(Increase) decrease in assets:		
Trade accounts receivable, net	(484)	7,446
Inventories	9,067	9,987
Refundable and accrued income taxes	1,884	(1,082)
Prepaid expenses and other	(145)	(439)
Other	(313)	(640)
Increase (decrease) in liabilities:		
Trade accounts payable	3,945	(5,383)
Accrued advertising and promotion	(4,418)	(8,046)
Accrued salaries, benefits, and payroll taxes	966	(5,348)
Accrued warranty and customer returns	100	(100)
Accrued other	636	1,050

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Total adjustments	14,811	796
Net cash from operating activities	16,985	1,876
Cash flows from investing activities:		
Purchases of tooling, property, plant, and equipment, net	(1,013)	(3,986)
(Increase) decrease in tooling deposits and other	(2,690)	197
Net cash from investing activities	(3,703)	(3,789)
Cash flows from financing activities:		
(Payments) proceeds on bank debt, net	(12,850)	7,745
Payments on note payable	-	(73)
Payments on capital lease obligations	(32)	(75)
Repurchase of common stock	-	(6,274)
Net cash from financing activities	(12,882)	1,323
Net increase (decrease) in cash	400	(590)
Cash at beginning of period	704	1,427
Cash at end of period	\$ 1,104	\$ 837
Supplemental disclosure of cash flow information:		
Cash payments for:		
Interest	\$ 875	\$ 783
Income taxes, net of refunds	\$ (509)	\$ 1,795

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

ROYAL APPLIANCE MFG. CO. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

NOTE 1: BASIS OF PRESENTATION

The financial information for Royal Appliance Mfg. Co. and Subsidiaries (the Company) included herein is unaudited; however, such information reflects all adjustments (consisting solely of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the consolidated statements of financial position as of March 31, 2001 and December 31, 2000, and the related statements of operations and cash flows as of, and for the interim periods ended, March 31, 2001 and 2000. These condensed financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's latest shareholders' annual report (Form 10-K).

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The results of operations for the three month period ended March 31, 2001, are not necessarily indicative of the results to be expected for the full year.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts and related disclosures. Actual results could differ from those estimates.

Net income per share is computed based on the weighted average number of common shares outstanding for basic earnings per share and on the weighted average number of common shares and common share equivalents outstanding for diluted earnings per share.

The Company's revenue recognition policy is to recognize revenues when products are shipped. The Company's return policy is to replace, repair or issue credit for product under warranty. Returns received during the current period are expensed as received and a provision is provided for estimated future returns based on current shipments. All sales are final upon shipment of goods to the customers. The Company's revenue recognition policy is in accordance with Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements."

International operations, primarily Canadian, are conducted in their local currency. Assets and liabilities denominated in foreign currencies are translated at current exchange rates, and income and expenses are translated using weighted average exchange rates. The net effect of currency gains and losses realized on these business transactions is included in the determination of net income.

The Company uses forward exchange contracts to reduce fluctuations in foreign currency cash flows related to receivables denominated in foreign currencies. The terms of the currency instruments are consistent with the timing of the transactions being hedged. The purpose of the Company's foreign currency management activity is to protect the Company from the risk that the eventual cash flows from the foreign currency denominated transactions may be adversely affected by changes in exchange rates. Gains and losses on forward exchange contracts are deferred and recognized in income when the related transactions being hedged are recognized. Such gains and losses are generally reported on the same financial line as the hedged transaction. The Company does not use derivative financial instruments for trading or speculative purposes. Outstanding as of March 31, 2001 and December 31, 2000 were \$0 and \$2,670, respectively, in contracts to purchase foreign currency forward. There is no significant unrealized gain or loss on these contracts. All contracts have terms of four months or less.

6

7

ROYAL APPLIANCE MFG. CO. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

NOTE 2: INVENTORIES

Inventories are stated at the lower of cost or market using the first-in, first-out (FIFO) method. Inventories at March 31, 2001, and December

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31, 2000, consisted of the following:

	March 31, 2001 ----	December 31, 2000 ----
Finished goods	\$26,234	\$37,832
Work in process and purchased parts	10,169 -----	7,638 -----
	\$36,403 =====	\$45,470 =====

NOTE 3: ASSETS TO BE DISPOSED OF:

Based upon a plan established in January 2001, the Company will discontinue operations at its former distribution and assembly center during the second quarter of 2001. The property has been listed with a real estate broker and the Company believes that the property will be sold for a price that exceeds the net book value as of March 31, 2001.

As of March 31, 2001, the building and related land and improvements are classified as "Assets to be Disposed Of" in accordance with Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets to be Disposed Of." As such, there is no need to continue to depreciate these assets. For financial statement purposes, the asset value, including related accumulated depreciation, is included in Property, Plant and Equipment, at cost on the face of the Consolidated Balance Sheets.

NOTE 4: COMMITMENTS AND CONTINGENCIES

At March 31, 2001, the Company estimates having contractual commitments for future advertising and promotional expense of approximately \$9,000 including commitments for television advertising through December 31, 2001. Other contractual commitments for items in the normal course of business total approximately \$1,800.

The Hoover Company (Hoover) filed a lawsuit in federal court, in the Northern District of Ohio (case #1:00cv 0347), against the Company on February 4, 2000, under the patent, trademark, and unfair competition laws of the United States. The claim asserts the Company's Dirt Devil(R) Easy Steamer infringes certain patents held by Hoover. Hoover seeks damages, injunction of future production, and legal fees. The Company is vigorously defending the suit and believes that it is without merit. If Hoover were to prevail on all of its claims, it could have a material adverse effect on the consolidated financial position, results of operations, or cash flows of the Company.

The Company is involved in various other claims and litigation arising in the normal course of business. In the opinion of management, the ultimate resolution of these actions will not materially affect the consolidated financial position, results of operations, or cash flows of the Company.

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(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

NOTE 5: DEBT

At March 31, 2001, the Company had a reducing collateralized revolving credit facility with availability of up to \$72,000 and a maturity date of March 7, 2003. Under the agreement, pricing options of the bank's base lending rate and LIBOR rate are based on a defined formula. In addition, the Company pays a commitment fee based on a defined formula on the unused portion of the facility. The revolving credit facility contains covenants which require, among other things, the achievement of minimum net worth levels and the maintenance of certain financial ratios. The Company was in compliance with all applicable covenants as of March 31, 2001. The revolving credit facility is collateralized by the assets of the Company and prohibits the payment of cash dividends. As long as the Company remains in compliance with all covenants, the revolving credit facility permits additional share repurchases up to \$40,000, of which \$20,065 was utilized through March 31, 2001.

The Company also utilizes a revolving trade accounts receivable securitization program to sell without recourse, through a wholly-owned subsidiary, certain trade accounts receivable. Under the program, the maximum amount allowed to be sold at any given time through March 31, 2001, was \$30,000. At March 31, 2001, the Company had received approximately \$24,800 from the sale of trade accounts receivable that has not yet been collected. The proceeds from the sales were used to reduce borrowings under the Company's revolving credit facility. Costs of the program, which primarily consist of the purchaser's financing cost of issuing commercial paper backed by the receivables, totaled \$322 and \$378 for the three months ended March 31, 2001 and 2000, respectively, and have been classified as "Receivable securitization and other expense, net" in the accompanying Consolidated Statements of Operations. The Company, as agent for the purchaser of the receivables, retains collection and administrative responsibilities for the purchased receivables. Additionally, the revolving trade accounts receivable securitization program limits stock repurchases to \$5,000 for 2001.

NOTE 6: SHARE REPURCHASE PROGRAM

In April 2001, the Company's Board of Directors authorized a common share repurchase program that provides for the Company to purchase, in the open market and through negotiated transactions, up to 3,400 of its outstanding common shares. As of May 4, 2001, the Company has repurchased approximately 61 shares for an aggregate purchase price of \$286 under the new program that is scheduled to expire in December 2002. One of the Company's credit facilities limits 2001 stock repurchases to \$5,000.

8

9

ROYAL APPLIANCE MFG. CO. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
(UNAUDITED)

(In thousands, except per share amounts)

NOTE 7: EARNINGS PER SHARE

The Company follows Statement of Financial Accounting Standards ("SFAS") No. 128, Earnings per Share, for the calculation of earnings per share. Basic earnings per share excludes dilution and is computed by dividing income by the weighted average number of common shares outstanding for the period. Diluted earnings per share includes the dilution of common stock equivalents.

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	Three months ended March 31,	
	2001	2000
Net income	\$ 2,174	\$ 1,080
BASIC:		
Common shares outstanding, net of treasury shares, beginning of period	13,729	16,973
Weighted average common shares issued during period	-	1
Weighted average treasury shares repurchased during period	-	(503)
Weighted average common shares outstanding, net of treasury shares, end of period	13,729	16,471
Net income per common share	\$ 0.16	\$ 0.07
DILUTED:		
Common shares outstanding, net of treasury shares, beginning of period	13,729	16,973
Weighted average common shares issued during period	-	1
Weighted average common share equivalents	502	246
Weighted average treasury shares repurchased during period	-	(503)
Weighted average common shares outstanding, net of treasury shares, end of period	14,231	16,717
Net income per common share	\$ 0.15	\$ 0.06

9

10

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

RESULTS OF OPERATIONS

Net sales increased 1.0% for the first quarter ended March 31, 2001, compared with the same period in the prior year. The increase in the first quarter net sales was due primarily to higher shipments of certain upright vacuum cleaners. Overall sales to the top 5 customers (all of which are major retailers) increased in the first three months of 2001, and increased as a percentage of total net sales, accounting for approximately 74.5% as compared with approximately 70.1% in the first three months of 2000. The Company believes that its dependence on sales to its largest customers will continue. Recently, some major retailers have experienced significant financial difficulties and some have filed for protection from creditors under applicable bankruptcy laws.

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The Company sells its products to certain customers that are in bankruptcy proceedings.

Gross margin, as a percent of net sales, decreased from 22.7% for the first quarter 2000 to 21.7% in the first quarter 2001. The gross margin percentage was negatively affected in 2001 by lower average wholesale selling prices on the Company's line of uprights due to continued heightened competition despite higher unit sales. Gross margins were also negatively impacted due to higher variable incentive compensation which was partially offset by lower product returns.

Advertising and promotion expenses decreased 27.9% for the first quarter 2001 compared with the first quarter 2000, and decreased as a percentage of net sales from 11.6% for the quarter ended March 31, 2000 to 8.3% for the quarter ended March 31, 2001. The decrease in advertising and promotion expenses was due primarily to decreases in media spending and cooperative advertising. However, the Company intends to continue emphasizing cooperative advertising and television as its primary methods of advertising and promotion. In general, the Company's advertising expenditures are not specifically proportional to anticipated sales. For example, the amount of advertising and promotional expenditures may be concentrated during critical retail shopping periods during the year, particularly the fourth quarter, and during new product and promotional campaign introductions.

Other selling expenses for the first quarter 2001 increased by \$502 over the first quarter 2000 and increased as a percentage of sales for the first quarter 2001 to 2.4% from 1.9% for the first quarter of 2000. The increase is primarily due to internal sales and marketing personnel compensation, which are the largest components of other selling expenses.

General and administrative expenses increased 1.8% for the first quarter 2001, compared with the first quarter in 2000, but was comparable as a percentage of net sales. The principal components are compensation (including benefits), insurance, and professional services. The dollar increase in the first quarter 2001 was primarily due to increases in employee related benefit expenses.

Engineering and product development expenses increased 9.4% for the first quarter 2001 compared with the first quarter in 2000. The principal components are engineering salaries, outside professional engineering and design services and other related product development expenditures. The amount of outside professional engineering and design services and other related product development expenditures are dependent upon the number and complexity of new product introductions in any given period. The increase in the first quarter 2001 was primarily due to costs associated with new product introductions in 2001 and the timing of those introductions.

Interest expense increased 9.6% for the first quarter 2001, compared with the first quarter in 2000. The increase in interest expense is the result of higher levels of variable rate borrowings to finance working capital, capital expenditures and share repurchases.

Receivable securitization and other expense, net, principally reflects the effect of the cost of the Company's trade accounts receivable securitization program and foreign currency transaction gains or losses related to the Company's North American assets.

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ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS ----- OF OPERATIONS (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) (CONTINUED) -----

RESULTS OF OPERATIONS (CONTINUED) -----

Due to the factors discussed above, the Company had income before income taxes for the first quarter 2001 of \$3,371 compared to income before income taxes for the first quarter 2000 of \$1,707.

LIQUIDITY AND CAPITAL RESOURCES -----

The Company has used cash generated from operations during the quarter ended March 31, 2001 to fund its capital expenditures and make payments on its revolving line of credit facility. Working capital was \$28,434 at March 31, 2001, a decrease of 28.7% over December 31, 2000. Current assets decreased by \$8,648 reflecting in part a decrease in inventory of \$9,067, and a decrease in deferred and refundable income taxes of \$610 partially offset by an increase in trade accounts receivable of \$484, and increased prepaid expenses and other of \$145. Current liabilities increased by \$2,803 reflecting in part a \$3,945 increase in accounts payable, \$1,572 increase in accrued taxes, a \$966 increase in accrued salaries, benefits, and payroll taxes and a \$636 increase in accrued other, partially offset by a decrease of \$4,418 in accrued advertising and promotion.

In the first three months of 2001, the Company utilized \$3,703 of cash for capital purchases, including approximately \$1,740 of tooling related to the new Platinum Force Extractor, Upright and Hand Vac.

At March 31, 2001, the Company had a reducing collateralized revolving credit facility with availability of up to \$72,000 and a maturity date of March 7, 2003. Under the agreement, pricing options of the bank's base lending rate and LIBOR rate are based on a defined formula. In addition, the Company pays a commitment fee based on a defined formula on the unused portion of the facility. The revolving credit facility contains covenants which require, among other things, the achievement of minimum net worth levels and the maintenance of certain financial ratios. The Company was in compliance with all applicable covenants as of March 31, 2001. The revolving credit facility is collateralized by the assets of the Company and prohibits the payment of cash dividends. As long as the Company remains in compliance with all covenants, the revolving credit facility permits additional share repurchases up to \$40,000, of which \$20,065 was utilized through March 31, 2001.

The Company also utilizes a revolving trade accounts receivable securitization program to sell without recourse, through a wholly-owned subsidiary, certain trade accounts receivable. Under the program, the maximum amount allowed to be sold at any given time through March 31, 2001, was \$30,000. At March 31, 2001, the Company had received approximately \$24,800 from the sale of trade accounts receivable that has not yet been collected. The proceeds from the sales were used to reduce borrowings under the Company's revolving credit facility. Costs of the program, which primarily consist of the purchaser's financing cost of issuing commercial paper backed by the receivables, totaled \$322 and \$378 for the three months ended March 31, 2001 and 2000, respectively, and have been classified as "Receivable securitization and other expense, net" in the accompanying Consolidated Statements of Operations. The Company, as agent for the purchaser of the receivables, retains collection and administrative responsibilities for the purchased receivables. Additionally, the revolving trade accounts receivable securitization program limits stock repurchases to \$5,000 for 2001.

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In April 2001, the Company's Board of Directors authorized a common share repurchase program that provides for the Company to purchase, in the open market and through negotiated transactions, up to 3,400 of its outstanding common shares. As of May 4, 2001, the Company has repurchased approximately 61 shares for an aggregate purchase price of \$286 under the new program that is scheduled to expire in December 2002. One of the Company's credit facilities limits 2001 stock repurchases to \$5,000.

The Company believes that its revolving credit facilities along with cash generated by operations will be sufficient to provide for the Company's anticipated working capital and capital expenditure requirements for the next twelve months, as well as any additional stock repurchases under the current repurchase program.

11

12

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS

OF OPERATIONS (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) (CONTINUED)

QUARTERLY OPERATING RESULTS

The following table presents certain unaudited consolidated quarterly operating information for the Company and includes all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for a fair presentation of such information for the interim periods.

	Three Months Ended				
	March 31, 2001 ----	Dec. 31, 2000 ----	Sept. 30, 2000 ----	June 30, 2000 ----	March 31, 2000 ----
Net sales	\$104,522	\$126,549	\$ 96,129	\$ 82,075	\$103,470
Gross margin	22,634	31,690	21,778	15,451	23,455
Net income (loss)	2,174	3,018	3,345	(1,504)	1,080
Net income (loss) per share - diluted (a)	\$ 0.15	\$ 0.21	\$ 0.22	\$ (0.10)	\$ 0.06

(a) The sum of 2000 quarterly net income (loss) per common share does not equal annual net income per common share due to the change in the weighted average number of common shares outstanding due to share repurchases.

The Company believes that a significant percentage of certain of its products are given as gifts and therefore, sell in larger volumes during the Christmas and other shopping seasons. Because of the Company's continued dependency on its major customers, the timing of purchases by these major customers and the timing of new product introductions cause quarterly fluctuations in the Company's net sales. As a consequence, results in prior

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quarters are not necessarily indicative of future results of operations.

OTHER

The Company's most significant competitors are Hoover, Eureka and Bissell in the upright vacuum and carpet shampooer markets and, in the hand-held market, Black & Decker. Most of these competitors and several others are subsidiaries or divisions of companies that are more diversified and have greater financial resources than the Company. The Company believes that the domestic vacuum cleaner industry is a mature industry with modest annual growth in many of its products but with a decline in certain other products. Competition is dependent upon price, quality, extension of product lines, and advertising and promotion expenditures. Additionally, competition is influenced by innovation in the design of replacement models and by marketing and approaches to distribution. The Company has experienced heightened competition, including price pressure and increased advertising by its competitors, in the upright and carpet shampooer market segments as a result of the Company's recent new product successes.

12

13

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS ----- OF OPERATIONS (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) (CONTINUED) -----

INFLATION

The Company does not believe that inflation by itself has had a material effect on the Company's results of operations. However, as the Company experiences price increases from its suppliers, which may include increases due to inflation, retail pressures may prevent the Company from increasing its prices. Due to the recent economic conditions, the cost of plastic resin and transportation has increased in 2001.

LITIGATION

The Hoover Company (Hoover) filed a lawsuit in federal court, in the Northern District of Ohio (case #1:00cv 0347), against the Company on February 4, 2000, under the patent, trademark, and unfair competition laws of the United States. The claim asserts the Company's Dirt Devil(R) Easy Steamer infringes certain patents held by Hoover. Hoover seeks damages, injunction of future production, and legal fees. The Company is vigorously defending the suit and believes that it is without merit. If Hoover were to prevail on all of its claims, it could have a material adverse effect on the consolidated financial position, results of operations, or cash flows of the Company.

The Company is involved in various other claims and litigation arising in the normal course of business. In the opinion of management, the ultimate resolution of these actions will not materially affect the consolidated financial position, results of operations, or cash flows of the Company.

ACCOUNTING STANDARDS

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The Company implemented Statement of Financial Accounting Standards ("SFAS") No. 133, Accounting for Derivative Instruments and Hedging Activities, in the first quarter of 2001. Implementation of SFAS No. 133 did not have a material impact on its consolidated financial position, results of operations, or cash flows.

FORWARD-LOOKING STATEMENTS

Forward-looking statements in this Form 10-Q are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those projected. Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. Potential risks and uncertainties include, but are not limited to: general business and economic conditions; the financial strength of the retail industry particularly the major mass retail channel; the competitive pricing and aggressive product development environment, particularly in the bagless upright vacuum category within the floor care industry; the impact of private-label programs by mass retailers; the cost and effectiveness of planned advertising, marketing and promotional campaigns; the success at retail and the acceptance by consumers of the Company's new products, including the Company's bagless uprights, carpet shampoos and its first consumer electronics product, the Telezapper; the dependence upon the Company's ability to continue to successfully develop and introduce innovative products; and the uncertainty of the Company's global suppliers to continuously supply sourced finished goods and component parts.

13

14

PART II - OTHER INFORMATION

ITEM 6 - Exhibits and Reports on Form 8-K

Forms 8-K - None

The following documents are furnished as an exhibit and numbered pursuant to Item 601 of Regulation S-K:

None

14

15

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.

Royal Appliance Mfg. Co.

(Registrant)

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/s/ Michael J. Merriman

Michael J. Merriman
Chief Executive Officer, President and Director
(Principal Executive Officer)

Date: May 4, 2001

/s/ Richard G. Vasek

Richard G. Vasek
Chief Financial Officer, Vice President -
Finance and Secretary (Principal Financial
Officer)

16

15

INDEX TO EXHIBITS

PAGE NUMBER

- | | |
|--------|---|
| 10 (N) | Promissory Note dated April 2, 2001 between Michael J. Merriman and the Registrant |
| 10 (O) | Stock Pledge Agreement dated April 2, 2001 between Michael J. Merriman and the Registrant |

16