AEROSONIC CORP /DE/
Form 10-K
May 01, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of
The Securities Exchange Act of 1934

For the Fiscal Year Ended January 31, 2013
Commission File Number 1-11750

AEROSONIC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**74-1668471**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1212 North Hercules Avenue
Clearwater, Florida 33765
(Address of principal executive offices and Zip Code)

Registrant's telephone number, including area code: (727) 461-3000

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

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $.40 par value	NYSE MKT

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

None.

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

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

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 (the "Exchange Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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 ¨.

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 definition of "large accelerated filer", "large accelerated filer", "non-accelerated filer and "small reporting company" in Rule 12b-2 of the Exchange Act. (Check one)

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

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

The aggregate market value of the common stock held by non-affiliates of the registrant as of July 27, 2012, the last business day of the registrant's most recently completed second quarter was approximately $13,633,000, based upon the closing price of the common stock on the NYSE MKT on that date.

As of May 1, 2013, the issuer had 4,020,334 shares of Common Stock outstanding, net of treasury shares.

Documents Incorporated by Reference:

Incorporation by reference: Portions of registrant's definitive proxy statement for the 2013 Annual Meeting of Stockholders to be held July 18, 2013 into Part III of this Form 10-K. The definitive proxy statement or an amendment to this Annual Report on Form 10-K is expected to be filed with the Securities and Exchange Commission within 120 days after the close of the fiscal year covered by this Form 10-K.

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Forward-Looking Statements

Unless stated to the contrary, or unless the context otherwise requires, references to “Aerosonic,” “the Company,” “we,” “our” or “us” in this report include Aerosonic Corporation and its subsidiaries.

Certain statements made in this Annual Report on Form 10-K that are not statements of historical or current facts are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from historical results or from any future results expressed or implied by such forward-looking statements.

In addition to statements that explicitly describe such risks and uncertainties, readers are urged to consider statements in future or conditional tenses or, include terms such as “believes,” “belief,” “expects,” “intends,” “anticipates” or “plans” to be uncertain and forward-looking. Forward-looking statements may include comments as to our beliefs and expectations as to future events and trends affecting our business. Forward-looking statements are based upon management’s current expectations concerning future events and trends and are necessarily subject to uncertainties, many of which are outside of our control. The factors set forth in Item 1A. Risk Factors, as well as other factors, could cause our actual results to differ materially from those reflected or predicted in forward-looking statements.

If one or more of these or other risks or uncertainties materialize, or if the underlying assumptions prove to be incorrect, actual results may vary materially from those reflected in or suggested by forward-looking statements. Any forward-looking statement you read in this Annual Report on Form 10-K reflects our current views with respect to future events and is subject to these and other risks, uncertainties and assumptions relating to our operations, results of operations, growth strategy and liquidity. All subsequent written and oral forward-looking statements attributable to us or individuals acting on our behalf are expressly qualified in their entirety by this paragraph. You should specifically consider the factors identified in this Annual Report on Form 10-K that would cause actual results to differ from those referred to in forward-looking statements.

Any forward-looking statements are based on management’s beliefs and assumptions, using information currently available to us. We assume no obligation for updating, and do not intend to update, these forward-looking statements.

We have a January 31 fiscal year end. Accordingly, all references in this Annual Report on Form 10-K to a fiscal year mean the fiscal year ended on January 31 of the referenced year; for example, references to fiscal year 2013 mean the fiscal year ended January 31, 2013.

PART I

ITEM 1. BUSINESS

General

We are a Delaware corporation formerly known as Instrument Technology Corporation ("ITC"). ITC, which was incorporated in 1968, was the surviving corporation of a merger, in 1970, with Aerosonic Corp., a Florida corporation. Aerosonic Corp., which was incorporated in 1957, ceased to exist as a separate corporation as a result of the merger. Following the merger, ITC changed its name to Aerosonic Corporation. In January 1993, we acquired Avionics Specialties, Inc. ("Avionics"), a Virginia corporation located in Earlysville, Virginia, from Teledyne Industries, Inc. ("Teledyne"). Avionics was previously a division of Teledyne. In fiscal year 2008, we commenced the consolidation of the Avionics operations with our Clearwater, Florida location. Avionics remains a wholly-owned subsidiary of the Company.

During fiscal year 2012, we completed the relocation of substantially all of our Avionics' manufacturing and repair/overhaul capabilities from Virginia into our Clearwater, Florida facility. Additionally, during fiscal year 2013, we continued our efforts to sell the Earlysville facility.

We are principally engaged in one business segment, which is the manufacture and sale of aircraft instruments and sensors. We design and manufacture both mechanical and digital altimeters, airspeed indicators, rate of climb indicators, microprocessor controlled air data test sets, and a variety of other flight instrumentation. Additionally, we design and manufacture angle of attack stall warning systems; integrated multifunction probes, which are integrated air data sensors; and other aircraft sensors and monitoring systems.

Merger Agreement

On April 19, 2013, we entered into an Agreement and Plan of Merger (the "Merger Agreement") with TransDigm Group Incorporated ("TransDigm"), and Buccaneer Acquisition Sub Inc. ("Purchaser"), an indirect wholly-owned subsidiary of TransDigm. Pursuant to the Merger Agreement, and on the terms and subject to the conditions described in the Merger Agreement, TransDigm agreed to conduct a cash tender offer (the "Offer") to purchase all of our issued and outstanding shares of common stock (the "Shares"), at a price of $7.75 per share in cash, without interest (less any applicable withholding taxes). Following the successful completion of the Offer, and subject to the terms and conditions of the Merger Agreement, Purchaser will be merged with and into the Company, with the Company surviving as an indirect wholly-owned subsidiary of TransDigm.

The obligation of TransDigm and Purchaser to consummate the Offer is subject to customary conditions, including but not limited to: (a) at least a majority of the outstanding Shares (determined on a fully-diluted basis) having been validly tendered and not withdrawn prior to the expiration of the Offer; and (b) there having occurred no Change in Recommendation (as defined in the Merger Agreement) by our Board of Directors. The Merger Agreement permits us to solicit alternative acquisition proposals from third parties for 40 days, until May 29, 2013. There is no assurance that this process will result in an alternative transaction.

This Form 10-K is not an offer to purchase or a solicitation of an offer to sell our securities. The planned tender offer by TransDigm for all of our outstanding shares of common stock has not been commenced. On commencement of the tender offer, TransDigm will mail to our stockholders an offer to purchase and related materials and we will mail to our stockholders a solicitation/recommendation statement with respect to the tender offer. Purchaser will file its offer to purchase with the Securities and Exchange Commission (the "SEC") on Schedule TO, and we will file its solicitation/recommendation statement with the SEC on Schedule 14D-9. Our stockholders are urged to read these materials carefully when they become available, since they will contain important information, including terms and conditions of the offer. Our stockholders may obtain a free copy of these materials (when they become available) and other documents filed by Purchaser or us with the SEC at the website maintained by the SEC at www.sec.gov. These materials also may be obtained (when they become available) for free by contacting the information agent for the

tender offer (when one is selected).

Industry

Military original equipment manufacturers (“OEMs”), such as BAE Systems, Bell Helicopter, Korea Aerospace Industries, Lockheed Martin Corporation, Alenia Aermacchi, Sikorsky Aircraft Corporation and The Boeing Company (“Boeing”) increasingly rely on subcontractors to carry a greater share of aircraft design scope, including system requirements, hardware and software design, and physical and electrical interfaces. Supporting this increased need has enabled us to develop a greater technical capability for serving our customer base. Our increased technical capability has also positioned us to push further into the commercial aircraft market with new technologies. We continue to work with customers to identify new products and new product application opportunities and we are exploring the design and development of core technologies that will have applications across our product lines. This will allow us to better control obsolescence and reduce material costs while increasing capability.

We are an aerospace industry leader in the design and manufacturing of aircraft instrumentation, air data sensing and air data test equipment. Our instrumentation products are used for both primary flight data and standby redundant instrumentation in cockpits. Our electronic displays are used for primary and standby flight data representation. As cockpit panel space becomes more valuable in the new age of glass displays, we have maintained a strong position with OEMs as a premier supplier of quality aircraft instrumentation in the military, general aviation and commercial aircraft marketplaces. Our air data sensing product line offers a broad range of air data and aircraft attitude sensing devices ranging from Angle of Attack (AoA) sensors, Stall Warning Transmitters (SWT) and Integrated Multi-Function Probes (IMFP®) to leading-edge Modular Static Flush Port (MSFP) technology. This range of products allows us to offer a fully integrated avionics package from air data to display and backup instrumentation thus reducing the number of suppliers required on the aircraft. Interest in our MSFP and derivative products has come from manufacturers of new manned and unmanned aircraft from around the world demonstrating the unique nature of this product. Variants of current production/development products have been named for integration on three of the latest technology aircraft in the US, Korea and Japan.

We are moving rapidly through the development cycle on the OASIS® backup display system. This product makes the latest technology in backup systems available to a broader range of aircraft through innovative design and affordable pricing.

Building on our expertise with mechanical instrumentation, we successfully developed and marketed digital instrumentation and displays for both primary flight data systems and standby redundant systems to complement our mechanical line of business. Continued development and enhancement of current technology has yielded an advanced anti-icing design for legacy air data systems as well as a number of technology enhancing implementations for both military and commercial aircraft including entry into the Transport aircraft category and a variety of advanced technology fighter and unmanned aerial vehicle (“UAV”) opportunities.

Our current market focus continues to be design, development and supply of electronic and mechanical primary and standby flight control systems components and instruments. These include altimeters, airspeed indicators, angle of attack indicators, stall warning systems, air data measurement/computation systems and flight display systems. All of these products are critical elements in the aircrew’s ability to reliably assess aircraft performance and to safely and efficiently operate aircraft in the international airspace environment.

As a small company, it is imperative that we have the ability to add expertise as required to respond to demanding development efforts. As such we have developed advantageous relationships with test laboratories, design and development companies, and subject matter experts allowing us to “right size” our capabilities in response to contract and research necessities.

In conjunction with our development and production activities, Aerosonic has developed expertise in the build, test and validation of critical test equipment including ESS chambers and wind tunnels. Aerosonic is expanding that

knowledge to offer customers the ability to order turnkey solutions to their test needs.

Strategy

Our market objectives are to deliver increasing value to our customers in three primary ways. First, because Aerosonic has a large installed base with many existing aircraft, as well as many long-standing relationships with global OEMs, we are working to ensure that our service, repair, and overhaul operations provide effective product support. This is a significant driver of customer satisfaction and financial contribution for our business. Second, we continuously strive to improve our ability to deliver new production on-time to customers' exacting manufacturing schedules and technical specifications. Aircraft manufacturers are focused on increasingly lean and cost-effective supply chains and we are working to ensure that we support their initiatives. Third, and most important from a growth perspective, we strive to design and deploy new products that enable our customers to deliver upgraded and/or new aircraft models. An important example of this is our work to develop digital instrumentation to replace aging mechanical designs. We have specialized air sensor, information processing, data presentation, design methodology, and manufacturing process knowledge that enables us to develop product solutions that enhance pilot performance and aircraft safety. Continually reinvesting and building on that capability in support of our customers is one of our core commitments.

Our business strategy is supported by our Company values, whereby we strive every day to be the best in the world at what we do. Our stated values include customer focus, open communication, honesty, mutual respect, trust, a bias for action, teamwork, leadership and other values that we believe attract good people, help retain the best and support high performance. We expect that, over time, a team of people dedicated to serving our stakeholders based on these shared values will lead to the success and growth of our Company.

Products and Distribution

Our products are sold to manufacturers of commercial and private aircraft, both domestic and foreign, and the United States ("U.S.") and numerous foreign military services. For the years ended January 31, 2013 and 2012, approximately 41% and 35%, respectively, of our sales were to the United States commercial sector. During these same two years, 33% and 44%, respectively, of our sales were either directly or indirectly to United States military services.

Additionally, we sell our products to customers outside of the U.S.. Our aggregate percentages of international sales to overall sales were 26% and 20% for our fiscal years 2013 and 2012, respectively.

Most of our instrument sales are made directly through our sales personnel to OEMs or to the United States military, with our remaining sales being made through distributors and commissioned sales representatives who resell to aircraft operators.

We produce a full line of mechanical and electro-mechanical cockpit instruments. These instruments operate independently of the aircraft electrical system, as they transfer valuable flight data to the pilot using only air pressure from aircraft probes as a power source.

We produce a leading-edge line of angle of attack ("AoA") stall warning products, including a "self-test" AoA sensor. We also produce Integrated Multi-Function Probes ("IMFP®"). This product combines existing technologies, including the angle of attack/air data sensing probe and pressure sensing electronics. We are one of a few developers of flush port air data technologies and are finalizing designs for both a Korean and European UCAV implementations using the same core technologies with prospects for further global expansion. Our air data devices also include stall warning transmitter ("SWT") and indicating devices. This integrated approach to providing aircraft air data reduces a customer's system complexity with respect to aircraft troubleshooting and logistics support, increases reliability, reduces supply complexity and decreases system costs.

We also produce digital cockpit instruments. These Technical Standard Order ("TSO") certified indicators combine accuracy, robustness and long-term reliability of digital electronic equipment, with a "pilot familiar" analog pointer display.

In 2007, we purchased the stock of OP Technologies, Inc. with the intention of completing any further development on its display product line that may have been required to obtain FAA certification. We dedicated significant resources and efforts in that regard, but it was not successful for a number of reasons including the economic environment and significant competition. Accordingly, on January 21, 2013, as part of our decision to discontinue further development and certification efforts on the Op Tech Flight Display product, we entered into a Development Collaboration and Intellectual Property Agreement with LG CNS Co., Ltd. ("LG"). The Collaboration Agreement provides for the sale of certain intellectual property of ours (the "Purchased IP") to LG. The aggregate purchase price for the Purchased IP is $2,300,000, $1,553,000 of which was already paid to us. The remainder of the purchase price is payable by LG to us in two lump sum payments in January 2016 and January 2017.

We are well into the development cycle of our new OASIS® Standby Display System. This product allows us to offer a next generation product that complements our highly successful line of standby instruments and systems. The OASIS® offers current technology with a flexible architecture that promotes ease of installation at a price that is already generating interest in the fixed wing and helicopter markets.

Customers

We primarily market our products to OEMs, particularly manufacturers of helicopters, corporate and private jets, and to contractors of military jets. Customers include, among others, the U.S. Government and a majority of the OEMs throughout the world. We also market our products to general aviation aircraft owners through our network of authorized distributors.

During fiscal year 2013, our largest customers, in terms of revenue, were the U.S. Government, Korea Aerospace Industries, Carp Industries and The Boeing Company, which represented 19%, 11%, 10% and 10% of total revenues, respectively. The loss of the U.S. Government, Korea Aerospace Industries or The Boeing Company as a customer would have a material adverse effect on our results of operations. Sales to Carp Industries are primarily sales of aftermarket parts that are sold through our distribution agreement. As such, we would expect these sales to survive any loss of the relationship with Carp Industries as that demand would transfer to one of our other distributors.

Contracts

Our contracts are normally for production or development and are generally firm fixed-price contracts. Our production contracts are typically fixed-price for a one year period with options to be exercised over a one to five year period with pricing targets established. The aerospace industry trend for such contracts continues to move away from five year contracts and toward contracts of shorter duration. We also secure purchase orders from customers for product sales in the normal course of our business that are binding contracts upon our acceptance of the terms and conditions of the orders.

Fixed-price contracts provide for a firm fixed-price on a variety of products and quantities of those products. Long-term contracts allow us to negotiate better overall prices that fit into customers' production programs. These long-term commitments also allow us to capitalize on quantity based price reduction for raw materials.

Under firm fixed-price contracts, we agree to perform for an agreed-upon price. Accordingly, we derive benefits from cost savings; however, we also bear the risk of cost overruns.

In accordance with normal practice, most of our contracts with the U.S. Government and its agencies and departments are subject to partial or complete termination at any time at the U.S. Government's convenience. Our government contracts generally contain provisions providing that in the event of a termination for convenience by the U.S. Government, we shall have the right to recover allowable costs incurred to the date of termination as well as a proportionate share of the profit on the work completed, consistent with U.S. Government contract regulations and procedures.

The inherent nature of the U.S. Government's contracting and budgeting process may affect our operating results and production backlog. Examples include the limited availability of year-end monies to accomplish important last minute contracts for supplies and services, enactment of continuing resolutions that limit spending to the previous year's level until a budget is signed into law, late approval of new budgets, and the use and timing of supplemental appropriations. These events significantly affect the amount of orders that we have in backlog and the number and size of major contracts for our products.

Sales and Marketing

We focus our sales efforts on government and military entities, OEMs and distributors. We continue to pursue additional aftermarket opportunities as well, given the slow OEM market and the resulting increase in retrofit, modification and repair programs.

Due to the integration of components manufactured by us with flight management systems, our sales force is generally involved at a very early stage with the aircraft manufacturers' engineers to integrate the components into the aircraft design. Our component instruments and systems are often integrated into the aircraft design helping to maintain and ensure the safe and effective operation of the aircraft.

At January 31, 2013, our backlog of firm orders was approximately $30.3 million, an increase of approximately $4.8 million when compared to our backlog as of January 31, 2012. The amount of backlog that is deliverable within twelve months was approximately $16.3 million at January 31, 2013, an increase of approximately $1.5 million when compared to January 31, 2012. The foregoing backlog amounts represent firm production and development orders only and do not include current contract options. Such option orders, however, may be subject to rescheduling and/or cancellation. Backlog amounts include business generated through repair and spare parts orders.

Government Regulation

The manufacture and installation of our products in aircraft owned and operated in the U.S. is governed by U.S. Federal Aviation Administration ("FAA") regulations. The regulations that have the most significant impact on us are the Technical Standards Order ("TSO") and Type Certificate or Supplemental Type Certificate ("STC") certifications. TSO outlines the minimum standards that a certain type of equipment must satisfy to be TSO certified. Many OEMs and retrofitters prefer TSO-certified aviation equipment because it acts as an aerospace industry-wide stamp of approval. We also sell our products to European and other non-U.S. OEMs, which typically require approval from the Joint Aviation Authorities ("JAA").

We have received TSO approval on over 400 different instruments, as well as 70 STCs. Most new instruments qualify for approval based on similarity. This provides a significant advantage to us and our customers by reducing the time required obtaining TSO approval on new instruments. We also have many instruments with JAA and development contractor approval.

Quality Assurance

Product quality is critical in the aerospace industry. We strive to maintain the highest standards within our operations.

We are ISO 9001/AS9100 certified. ISO 9001/AS9100 standards are an international consensus on effective management practices for ensuring that we can consistently deliver our products and related services in a manner that meets or exceeds customer quality requirements. ISO 9001/AS9100 standards outline the minimum requirements a quality system must meet to achieve this certification.

As an ISO 9001/AS9100 certified manufacturer, we can represent to our customers that we maintain high quality industry standards in the education of employees and the design and manufacture of our products. In addition, our products undergo extensive quality control testing prior to being delivered to customers. As part of our quality assurance procedures, we maintain detailed records of test results and quality control processes.

Patents and Licenses

We have patents on certain commercial and military products such as air data probes. We also have certain registered trademarks. This intellectual property portfolio, in the aggregate, is valuable to our operations; however, we do not believe the business, as a whole, is materially dependent on any single patent, trademark or copyright.

Research and Development

We expended approximately $4,948,000 and $2,719,000 in both internally and externally funded research and development (“R&D”) costs for potential new products and enhancements during the years ended January 31, 2013 and 2012, respectively.

We continued various development efforts during fiscal year 2013 for both military and commercial applications. Creating innovative digital, integrated standby devices has been a primary focus of our R&D efforts, along with additional advancements for our industry unique air data instruments. These efforts will provide for an integrated product line from sensors and information processing through primary and backup displays for the flight crew. Further, we plan to continue our design efforts to satisfy our existing contractual obligations as well as our internal development of products for future customer applications. This includes re-engineering of existing products and processes to improve manufacturability, increase reliability, enhance throughput, and reduce production costs.

Competition

Markets for our products are highly competitive and characterized by several aerospace industry niches in which a number of manufacturers specialize. In our market niche, we believe that we manufacture a broader variety of aircraft instruments than our competitors who, in most instances, compete with us on no more than a few types of aircraft instruments. In addition to mechanical instruments that formed the initial foundation of our business, we offer digital instruments and components that are integrated into the flight management system of aircraft. This product offering allows us to compete on many levels within the aerospace industry.

Our AoA, stall warning and IMFP® products provide flight critical functions and are typically designed to meet the requirements of a specific aircraft. Our rotating probe design provides a competitive advantage in terms of responsiveness and accuracy. There is limited competition in this product family.

We believe that our principal competitive factors are development cycle time, responsiveness to customer preferences, product quality, delivery reliability, price, technology, product reliability and product variety. We believe that our significant and long-standing customer relationships reflect our ability to compete favorably with respect to these factors.

Manufacturing, Assembly and Material Acquisition

Our manufacturing processes, except for certain electronic components, include the manufacture of all principal components and subassemblies for the instruments, the assembly of those components, and the testing of products at various stages in the manufacture and assembly process.

We manufacture, or have the capability to manufacture, principally all components, except for certain electronic components and subassemblies for our instruments. Raw materials, such as glass lenses, raw metals and castings, generally are available from a number of sources and in sufficient quantities to meet current requirements, subject to normal lead times. We believe that retaining the ability to completely manufacture the instruments allows us the flexibility to respond to customers quickly and control the quality of our products.

When appropriate, less critical component parts are purchased under short and long-term supply agreements. These purchased parts are normally standard parts that can be easily obtained from a variety of suppliers. This allows us to focus our attention on more critical component parts to maintain a level of quality control required to meet the exacting tolerances demanded within the aerospace industry and by our customers. Recently, we have increased the outsourcing of standard parts.

Employees

As of both January 31, 2013 and January 31, 2012, we employed 199 full time employees. Our future success depends on the ability to attract, train and retain quality personnel. Our employees are not represented by labor unions and we consider our relations with our employees to be good.

Available Information

Our most recent Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports may be viewed or downloaded electronically, free of charge, from our website: http://www.aerosonic.com as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. In addition, you may read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. To obtain information on the operation of the Public Reference Room, you may call the SEC at 1-800-SEC-0330. Our recent press releases are also available to be viewed or downloaded electronically at http://www.aerosonic.com. We will also provide electronic copies of our SEC filings free of charge upon request. Any information posted on or linked from our website is not incorporated by reference into this Annual Report on Form 10-K. The SEC also maintains a website at http://www.sec.gov, which contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC.

ITEM 1A. RISK FACTORS

The following factors are important and should be considered carefully in connection with any evaluation of our business, financial condition, results of operations, prospects, or an investment in our common stock. In particular, our results of operations, revenue, liquidity and capital resources may be materially and unfavorably affected by a number of risk factors, trends and uncertainties. Set forth below are the risk factors, trends and uncertainties which we believe could have a material and unfavorable impact on our results of operations, revenue, liquidity, capital resources and any investment in our stock. Additional risk factors, trends and uncertainties may be discussed elsewhere within this document.

Our business is dependent on the aerospace industry and defense spending

Our principal business is in the aerospace industry. Our commercial sector business is cyclically affected by the state of the economy. In the military sector, we are affected by overall spending levels in the defense budgets of the U.S.

and foreign governments, the priorities reflected in those budgets, and developments affecting the timing of those expenditures. Adverse developments in the economy generally, aerospace industry in particular, or government defense sector could have a material adverse effect on our results of operation.

A portion of our business is dependent on U.S. Government contracts

Our dependence on revenue from U.S. Government contracts subjects us to a number of risks, including the risk that we may not be successful in bidding for future contracts and the risk that funding for these contracts may be delayed or diverted to other uses.

We perform work under a number of contracts with the U.S. Department of Defense and other agencies and departments of the U.S. Government. Sales under these contracts as a whole, including sales under contracts with the U.S. Department of Defense, as prime contractor or subcontractor, represented approximately 33% and 44% of our total revenue for fiscal years 2013 and 2012, respectively.

U.S. Government contracts are conditioned upon the continuing availability of Congressional appropriations. Congress typically appropriates funds for a given program on a fiscal-year basis even though contract performance may take more than one year. As a result, at the beginning of a major program, a contract is typically only partially funded, and additional monies are normally committed to the contract by the procuring agency only as appropriations are made by Congress for future fiscal years.

Most of our U.S. Government contracts are subject to termination by the U.S. Government either at its convenience or upon our default. Termination-for-convenience provisions permit only the recovery of costs incurred or committed, settlement expenses, and profit on work completed prior to termination. Termination-for-default imposes liability on us for excess costs incurred by the U.S. Government in procuring undelivered items from another source.

A substantial majority of our U.S. Government contracts are fixed-price type contracts. A majority of these contracts are for mature products and costs are well established. However, some contracts include costs associated with product development. These types of contracts bear the inherent risk that actual performance cost may exceed the fixed contract price.

We, like other U.S. Government contractors, are subject to various audits, reviews and investigations (including private party “whistleblower” lawsuits) relating to our compliance with federal and state laws. In addition, we have a compliance program designed to uncover issues that may lead to voluntary disclosures to the U.S. Government. Generally, claims arising out of these inquiries and voluntary disclosures can be resolved without resorting to litigation. However, should the Company be charged with violation of law, or should the U.S. Government determine that the Company is not a “presently responsible contractor,” the Company could be temporarily suspended or, in the event of a violation, could be debarred for up to three years from receiving new U.S. Government contracts or government-approved subcontracts. In addition, we could expend substantial amounts in defending against such charges and in damages, fines and penalties if such charges are proven or result in negotiated settlements. If we were to be debarred from U.S. Government contracts, it would have a material adverse effect on our results of operations, revenue, liquidity, and capital resources.

Changes in levels of U.S. government defense spending or overall acquisition priorities could negatively impact our financial position and results of operations.

We derive a substantial portion of our revenue from the U.S. government, primarily from defense related programs with the U.S. Department of Defense (“U.S. DoD”). Levels of U.S. defense spending in future periods are very difficult to predict and subject to significant risks. In addition, significant budgetary constraints may result in further reductions to projected spending levels. In particular, U.S. government expenditures are subject to the potential for automatic reductions, generally referred to as "sequestration." Sequestration may occur during fiscal year 2014, resulting in significant additional reductions to spending by the U.S. DoD on both existing and new contracts as well as disruption of ongoing programs. Even if sequestration does not occur, we expect that budgetary constraints and ongoing concerns regarding the U.S. national debt will continue to place downward pressure on U.S. DoD spending levels. Due to these and other factors, overall U.S. government defense spending could decline, which could result in significant reductions to revenue, cash flow, profit and backlog in our business.

In addition, as a result of the significant ongoing uncertainty with respect to both U.S. defense spending levels and the nature of the threat environment, we expect the U.S. DoD to continue to emphasize cost-cutting and other efficiency

initiatives in its procurement processes. If we can no longer adjust successfully to these changing acquisition priorities and/or fail to meet affordability targets set by the U.S. DoD customer, our revenues and market share would be further impacted.

As part of the aerospace industry our business is heavily regulated and the cost of non-compliance with applicable regulations could be significant

The aerospace industry is heavily regulated and failure to comply with applicable laws or regulations could reduce our sales or require us to incur additional costs to achieve compliance, which could have a material adverse effect on our results of operations.

The FAA prescribes standards and licensing requirements for aircraft components, including virtually all of our products. Comparable agencies, such as the U.K. Civil Aviation Authority, the Japanese Civil Aviation Board and South Korea's Aviation Safety Authority regulate these matters in other countries.

If we fail to obtain a required license for one of our products or services or lose a license previously granted, the sale of the subject product or service would be prohibited by law until such license is obtained or renewed. In addition, designing new products to meet existing regulatory requirements and retrofitting installed products to comply with new regulatory requirements can be both expensive and time consuming.

From time to time the FAA proposes new regulations. These new regulations generally cause an increase in costs to bring our existing and developmental products into compliance. Indirect events in other segments of the sector such as design failures (e.g., Boeing's 787 Lithium Ion battery failures) can influence development and production while regulatory issues are resolved.

We have to compete against larger well-established companies that are well capitalized

We compete with numerous well-established companies. Some of these companies have significantly greater financial, technological and marketing resources than us. Our ability to be an effective competitor depends in large part on our success in causing our products to be selected for installation in new aircraft, including next generation aircraft, and in avoiding product obsolescence. In addition some of our larger customers could develop the capability to manufacture products or provide services similar to the products we manufacture or the services we provide. This could result in these customers competing directly with us for sales of these products or services, all of which could significantly reduce our revenues. There can be no assurance that we will be able to compete successfully against our current or future competitors or that the competitive pressures we face will not result in reduced revenues and market share.

We are engaged in a highly competitive marketplace, which demands that producers continue to develop new products. Our business will be adversely affected if we are not able to continue to develop new and competitive products

Our customers continually seek improvements in the products that we manufacture and market. As a result, in order to meet our customers' needs, we must continue to develop new products and innovations and enhancements to existing products. Many of our competitors have significantly more capital than we have and as a result have the ability to devote more resources to research and development and to marketing of their products. In order to remain competitive, we must continue to devote a material portion of our financial resources to research and development and there is no assurance that we will be successful in our product improvement efforts in our competitive marketplace.

We face continuous pricing pressure from our customers and our competitors. This will affect our margins and therefore our profitability and cash flow unless we can manage efficiently our manufacturing costs and market our products based on superior quality

Our customers often award contracts based on product pricing, and we believe we have not received some awards due to pricing discounts given by our competitors. Many of our competitors have significantly greater financial resources than we have, and as a result may be able to withstand the adverse effect of discounted pricing and reduced margins in order to build market share. While one of our strategies is also to discount to retain and increase market share and to seek to manage our manufacturing efficiently to sustain acceptable margins, we may not be able to maintain appropriate prices or to manage product manufacturing costs sufficiently to sustain acceptable margins. Similarly, we seek to compete based on product quality rather than price, but we may not be successful in these efforts with enough contract awards to offset the need to reduce prices for other products. This could adversely affect our profitability, our liquidity and our market share.

Increases in the prices paid for raw materials or labor costs may adversely affect profit margins

If we experience significant increases in the prices paid for raw materials or labor costs, we may not be able to pass through to our customers such increases in those costs. Even if we are able to pass through all or a portion of such cost increases to our customers, profit margins on such products may be reduced. Fixed-price contracts are especially susceptible to such profit margin reductions.

Our products are used in activities that are inherently risky. Accordingly, we may face product liability and exposure to other claims for which we may not be able to obtain adequate insurance

The products that we manufacture are typically used in applications and activities that involve high levels of risk of personal injury. Failure to use these products for their intended purposes, failure to use these products properly, malfunction of these products and, in some circumstances, even correct use of these products could result in serious bodily injury or death. We cannot guarantee that our insurance coverage would be sufficient to cover the payment of any potential claim arising out of the use of our products. In addition, we cannot guarantee that our current insurance or any other insurance coverage will continue to be available or, if available, that it will be obtainable at a reasonable cost. Any substantial uninsured loss thus would have to be paid out of our assets as applicable and may have a material adverse effect on our business, financial condition, results of operations and liquidity. If we are unable to obtain product liability coverage, then we may be prohibited from bidding for orders from certain government customers because many governmental agencies currently require such insurance coverage. Any inability to bid for government contracts as a result of insufficient insurance coverage would have a material adverse effect on our business, financial condition, results of operations and liquidity.

Our industry has rapid technological changes and products that are subject to obsolescence - as a result, we are developing new products that might not be successful

Our operating results depend in part on our ability to introduce new and enhanced products on a timely basis. Successful product development and introduction depend on numerous factors, including our ability to anticipate customer and market requirements, changes in technology and aerospace industry standards, our ability to differentiate our offerings from offerings of our competitors, and market acceptance. The markets for a number of our products and services are generally characterized by rapid technological development, evolving aerospace industry standards, changes in customer requirements and new product introductions and enhancements. A faster than anticipated change in one or more of the technologies related to our products or services or in market demand for products or services based on a particular technology could result in faster than anticipated obsolescence of certain of our products or services and could have a material adverse effect on our business, results of operations and financial condition. We might not be successful in our efforts to develop new products and technology that gain market acceptance. Currently accepted aerospace industry standards are also subject to change, which may contribute to the obsolescence of our products or services and could have a material adverse effect on our business, results of

operations and financial condition.

We face unforeseen liabilities arising from possible acquisitions and dispositions of businesses

We have engaged in acquisitions of businesses in the past, and expect to continue to do so in the future. There could be unforeseen liabilities that arise in connection with the businesses that we may acquire in the future. In addition, there may be liabilities that we fail, or we are unable, to discover in the course of performing due diligence investigations on each business that we have acquired or may acquire.

We are dependent on the ability to maintain reasonable levels of working capital along with capital needs for expansion

Our need to expend resources on research and development to provide our customer base with new and enhanced products as well as to continuously upgrade our process technology and manufacturing capabilities requires us to invest necessary resources on an annual basis. If we elect to expand our operations in future periods, whether as a result of organic growth or through strategic acquisitions, our capital needs would increase. Our ability to raise capital to meet our existing and future needs may depend on a variety of factors, some of which will not be within our control, including investor perceptions of us, our businesses and the industries in which we operate, and general economic conditions. We may be unable to successfully raise additional capital, if needed. If we are unable to generate sufficient cash from operations or raise additional capital in the future, we may have to limit our growth, enter into less favorable financing arrangements, or scale back on planned research and development or upgrades, any of which could have a materially adverse effect on our profitability.

We rely significantly on our ability to fill orders on a timely basis and collect accounts receivable for liquidity needs

Our liquidity depends on cash generated from operations. We have been challenged during fiscal years 2013 and 2012 to efficiently process orders, ship finished goods, and collect receivables in order to maintain liquidity. Should we continue to experience operational inefficiencies in any of these areas it will have an adverse effect on our financial condition, operating results and cash flows, as well as our ability to access credit markets and to obtain reasonable trade terms from our vendors.

We continue to experience liquidity challenges

In addition to debt service on our credit facilities, we have significant cash obligations that we must meet in the near future. Should we not be able to execute our business plan to meet our cash obligations, improve our cash flows from operations, contain costs related to the development of new products and continue to obtain reasonable vendor terms, our financial condition and operating results will continue to suffer. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources."

The terms of our credit facilities include various covenants, and failure to meet these covenants could affect our ability to borrow

Our Credit Facility with BMO Harris Bank, N.A. (“BMO Harris Bank”) requires us to maintain compliance with financial covenants that are based on total stockholders’ equity, ratio of funded debt to EBITDA covenant, and a fixed charge coverage ratio. We complied with all financial covenants as of and for the fiscal year ended January 31, 2013, however, we were not in compliance with certain financial covenants for the periods July 29, 2011 and October 28, 2011. The lender waived non-compliance for these periods and adjusted the funded debt to EBITDA covenant for our 2012 fiscal year, but there is no assurance that the lender will waive compliance or amend this Credit Facility in future periods, if such a waiver or amendment is needed. A default under the Credit Facility would adversely affect us. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources.”

Our Credit Facility with BMO Harris Bank is also subject to renewal provisions, including a maturity date for our Equipment Credit Line Note of May 1, 2014. This renewal may become more challenging as a result of our future financial position and credit constraints in the U.S. banking markets as a whole. Failure to obtain permanent financing may impair our liquidity.

We face risks associated with handling and use of hazardous substances and related environmental matters

Our operations require the handling and use of hazardous substances, and we are subject to federal, state and local laws, regulations, rules and ordinances relating to pollution, the protection of the environment and the use or cleanup of hazardous substances and wastes. From time to time, our operations could result in violations under such environmental laws, including spills or other releases of hazardous substances into the environment. We may incur substantial costs or experience interruptions in our operations for actual or alleged violations or compliance requirements arising under environmental laws. Additionally, we may be liable for the costs of investigating and cleaning up environmental contamination on or from our properties. In the event of a major incident, we could incur material costs or experience interruption in our operations as a result of addressing the incident and implementing measures to prevent such incidents in the future, as well as potential litigation that could arise from such an incident. In addition, we could incur significant expenditures in order to comply with existing or future environmental laws.

We face risks associated with international sales

During fiscal years 2013 and 2012, international sales accounted for approximately 26% and 20%, respectively, of our total revenues. We anticipate that future international sales will continue to account for a significant percentage of our revenues. Risks associated with these sales include:

- Political and economic instability;
- Export controls and other trade restrictions;
- Changes in legal and regulatory requirements;
- U.S. and foreign government policy changes affecting the markets for our products;
- Changes in tax laws and tariffs;
- Convertibility and transferability of international currencies; and
- International currency exchange rate fluctuations.

Any of these factors could have a material adverse effect on our business, results of operations and financial condition. Currency exchange rate fluctuations may negatively affect the cost of our products to international customers and therefore reduce our competitive position.

If we are unable to successfully attract and retain executive leadership and other key personnel, our ability to successfully develop and market our products and operate our business may be harmed

Our future success depends to a significant extent upon the continued service of our executive officers and other key management and technical personnel and on our ability to continue to attract, retain and motivate qualified personnel. Recruiting and retaining skilled technical personnel is highly competitive. The loss of the services of one or more of our key employees or our failure to attract, retain and motivate qualified personnel could have a material adverse effect on our business, financial condition and results of operations.

Terrorism and world conflict could adversely affect our ability to market our product

United States and global responses to the Middle East conflict, terrorism, perceived nuclear, biological and chemical threats and other global crises increase uncertainties with respect to U.S. and other business and financial markets. Several factors associated, directly or indirectly, with such crises and perceptions, including responses thereto, may adversely affect us.

While some of our products that are sold to the U.S. Government may experience greater demand as a result of increased defense spending, various responses could realign U.S. Government programs and affect the composition, funding or timing of our government programs. U.S. Government spending could shift to defense programs in which we do not participate.

We have contracts with the government of South Korea. Continued actions and perceived provocations by the government of North Korea have resulted in increased concern regarding the stability of the Korean armistice. Additionally, reports indicate that North Korea has moved to produce and test nuclear weapons or otherwise provoke the U.S. and international community. Resulting instability on the Korean peninsula, and any U.S., local or global responses to perceived provocations by the government of North Korea, could impact our contracts with South Korea. While an escalation of hostilities on the Korean peninsula might lead to increased military spending by South Korea, there is no certainty that our contracts with South Korea would benefit. Additionally, it is possible that any instability in that region could have a negative impact on our contracts.

Completion of the pending acquisition by TransDigm is uncertain

On April 22, 2013, we announced that we entered into the Merger Agreement for TransDigm to acquire us. Completion of this transaction is subject to conditions and there is no assurance that this process will lead to a completed transaction. The Merger Agreement permits us to solicit alternative acquisition proposals from third parties for 40 days, until May 29, 2013. There is no assurance that this process will result in an alternative transaction. In addition, this process may distract the attention of our Board of Directors and management from our business, cause us to incur significant expenses pursuing this transaction, or impair our relationships with customers, suppliers and employees. If we are unable to effectively manage these risks, our business, financial condition, or results of operations might be adversely affected.

Our stock price is volatile because it is affected by numerous factors outside of our control

The market price and trading volume of our common stock is subject to significant volatility and this trend may continue. The general economic, political, and stock market conditions that may affect the market prices of our common stock are outside our control. The value of our common stock may decline regardless of our operating performance or prospects. Factors affecting market price include, but are not limited to: (i) variations in our operating results and whether we have achieved our key business targets; (ii) the limited number of shares of our common stock available for purchase or sale in the public markets; (iii) sales or purchases of large blocks of stock; (iv) changes in, or failure to meet, earnings estimates; (v) changes in securities analysts' buy/sell recommendations; (vi) differences between reported results and those expected by investors and securities analysts; and (vii) announcements of new contracts by us or by our competitors. In the past, securities class action litigation has been instituted against companies following periods of volatility in the market price of their securities.

Other factors and general market conditions that could affect our stock price are:

• Our quarterly and annual operating results and variations therein;

• Changes in earnings estimates by securities analysts;

• Changes in our business;

• Changes in the market's perception of our business;

• Changes in the businesses, earnings estimates or market perceptions of our competitors or customers;

• Changes in the outlook for the aerospace industry;

• Changes in general market or economic conditions unrelated to our performance;

• Changes in the legislative or regulatory environment;

• Changes in U.S. defense spending or appropriations;

• Increased military or homeland defense activities;

• An outbreak or escalation of national or international hostilities;

• Terrorist attacks;

• Sales of significant blocks of our common stock; and

• Our ability to successfully maintain our line of credit.

Additionally, the stock market has experienced extreme price and volume fluctuations in recent years that have significantly affected the quoted prices of the securities of many companies, including companies in the aerospace industry. The changes often appear to occur without regard to specific operating performance. The price of our common stock could fluctuate based upon factors that have little or nothing to do with our business or performance and these fluctuations could materially reduce our stock price.

We do not plan to pay cash dividends on our common stock in the foreseeable future

We intend to retain our earnings to finance the development and expansion of our business. Additionally, covenants in our long-term debt agreements may restrict our ability to pay dividends. This lack of dividend could adversely affect the market for our common stock and the return on our common stock for our stockholders.

Our common stock may become subject to penny stock rules, which may make it more difficult for our stockholders to sell their common stock

Our common stock may become a “penny stock” pursuant to Rule 3a51-1 of the Exchange Act. Broker-dealer practices in connection with transactions in penny stocks are regulated by certain penny stock rules adopted by the SEC. Penny stocks generally are defined as equity securities with a price of less than $5.00 per share. The penny stock rules require a broker-dealer, prior to purchase or sale of a penny stock not otherwise exempt from the rules, to deliver to the customer a standardized risk disclosure document that provides information about penny stocks and the risks associated with the penny stock market. The broker-dealer also must provide the customer with current bid and offer quotations for the penny stock, the compensation of the broker-dealer and its salesperson in the transaction, and monthly account statements showing the market value of each penny stock held in the customer account. In addition, the penny stock rules generally require that, prior to a transaction in a penny stock, the broker-dealer make a special

written determination that the penny stock is a suitable investment for the purchaser and receive the purchaser's written agreement to the transaction. These disclosure requirements, that apply to any stock that becomes subject to the penny stock rules, may have the effect of reducing the level of trading activity of our stock in the secondary market.

We have risks related to the inherent limitations of internal control systems

Effective internal controls are necessary for us to provide reliable financial reports. If we cannot provide reliable financial reports, our operating results could be misstated, our reputation may be harmed and the trading price of our stock could be negatively affected. Our management has concluded that there are no material weaknesses in our internal controls over financial reporting as of January 31, 2013. However, there can be no assurance that our controls over financial processes and reporting will be effective in the future or that additional material weaknesses or significant deficiencies in our internal controls will not be discovered in the future. Any failure to remediate any future material weaknesses or implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results, cause us to fail to meet our reporting obligations or result in material misstatements in our financial statements or other public disclosures. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our stock.

We cannot guarantee that our internal controls and disclosure controls will prevent all error, loss, and fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect resource constraints and the benefit of controls relative to their costs.

Our forward-looking statements and projections may prove to be inaccurate

Our actual financial results likely will be different from those projected due to the inherent nature of projections and may be better or worse than projected. Given these uncertainties, you should not rely on any forward-looking statements that we provide. The forward-looking statements contained in this Form 10-K speak only as of the date of this Form 10-K. We expressly disclaim a duty to provide updates to forward-looking statements after the date of this Form 10-K to reflect the occurrence of subsequent events, changed circumstances, changes in our expectations, or the estimates and assumptions associated with them. The forward-looking statements in this Form 10-K are intended to be subject to the safe harbor protection provided by the federal securities laws.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not Applicable.

ITEM 2. PROPERTIES.

The following table sets forth the locations and general characteristics of our principal properties:

Location	Approximate Number of Square Feet of Plant and Office Area
Plant and office facilities, 1212 North Hercules Avenue, Clearwater, Florida (Owned)	61,000
Plant facility held for sale, 3369 Earlysville Road, Earlysville, Virginia (Owned)	53,000

On August 8, 2008, we suffered the destruction of one of the buildings comprising our Clearwater, Florida facility as a result of a fire. The Clearwater, Florida property, as reconfigured, is fully occupied by us and suitable for our present level of production.

In preparation for the sale of the Earlysville, Virginia facility, we engaged an environmental consulting firm to survey the property for any possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents by a former owner of the property. During fiscal year 2013, we signed an administrative order on consent with the U.S. Environmental Protection Agency to provide the former owner with access to the property and the former owner of the property signed an administrative order on consent with the U.S. Environmental Protection Agency for completion of a contamination characterization study. As a result of the initial and subsequent surveys, our responsibility for the remaining contamination treatment costs, future monitoring, oversight and other related costs is estimated at $404,000 as of January 31, 2013. We have capitalized these costs as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility and will not result in a carrying value in excess of the estimated fair value less cost to sell. Costs incurred during fiscal year 2013 totaled $22,000 and costs incurred during the fiscal year ended January 31, 2012 totaled $20,000. At this time, we cannot predict how much, if any, we will incur for more costs in fiscal year 2014.

On September 20, 2007, we signed a five-year operating lease at a much smaller 9,000 square foot facility in Charlottesville, Virginia to serve as our new location for support and repair/overhaul activities for existing Avionics Specialties products. During fiscal year 2012, substantially all of the support and repair/overhaul activities for existing Avionics Specialties products relocated from the leased facility in Charlottesville, Virginia to our facility in Clearwater, Florida. During fiscal year 2013, the operating lease in Charlottesville, Virginia terminated.

ITEM 3. LEGAL PROCEEDINGS

From time to time, we may be involved in certain claims and legal actions arising in the ordinary course of business. In the opinion of management, at this time, there are no material claims or legal actions at this time.

ITEM 4. MINE SAFETY DISCLOSURE

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON STOCK AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market for Common Stock and Dividends

Our common stock is listed on the NYSE MKT under the symbol "AIM." The range of high and low sales prices as reported by the NYSE MKT for each of the quarters of the fiscal years ended January 31, 2013 and January 31, 2012 was as follows:

	COMMON STOCK MARKET PRICE	
2013	HIGH	LOW
Fourth quarter	$ 3.90	$ 2.64
Third quarter	$ 3.83	$ 3.07
Second quarter	$ 4.21	$ 3.17
First quarter	$ 3.40	$ 2.35

2012	HIGH	LOW
Fourth quarter	$3.39	$2.15
Third quarter	$3.45	$2.25
Second quarter	$3.48	$2.86
First quarter	$3.70	$2.60

As of May 1, 2013, our outstanding shares of common stock were owned by approximately 2,000 stockholders of record.

During those same periods, no cash dividends were paid. We do not anticipate or intend on paying a dividend in the foreseeable future. Rather, we intend to retain our earnings to finance the development and expansion of our business. Additionally, covenants in our long-term debt documents may restrict our ability to pay dividends. Any future payment of any dividends on our common stock and the amount thereof will depend on our earnings, financial requirements, compliance with the above described covenants, and other factors deemed relevant by our Board of Directors.

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Securities Authorized for Issuance under Equity Compensation Plans

Information regarding our equity compensation plan at January 31, 2013 is summarized as follows:

Plan category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted average exercise price of outstanding warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	330,100	$ 2.87	419,900
Equity compensation plans not approved by security holders	None	N/A	N/A
Total	330,100	$ 2.87	419,900

Stock warrants issued to the Investors, as discussed in Note 7 of “Notes to Consolidated Financial Statements”, are not included in the above table as they were not issued from an equity compensation plan.

ITEM 6. SELECTED FINANCIAL DATA.

The following table represents selected financial data for the most recent five fiscal years ended January 31. The data set forth below does not purport to be complete. It should be read in conjunction with, and is qualified in its entirety by, the more detailed information, including the Consolidated Financial Statements and Notes, appearing elsewhere in this document. The selected financial data as of January 31, 2011, 2010 and 2009 and for the years ended January 31, 2011, 2010 and 2009 have been derived from audited financial information not separately presented herein.

	As of and for the Years Ended January 31,				
	2013	2012	2011	2010	2009
Revenues, net	$31,021,000	$29,607,000	$29,618,000	$31,136,000	$20,451,000
Cost of sales	(19,091,000)	(21,112,000)	(20,486,000)	(20,268,000)	(18,410,000)
Gross profit	11,930,000	8,495,000	9,132,000	10,868,000	2,041,000
Selling, general and administrative expenses	(10,152,000)	(7,154,000)	(7,415,000)	(6,725,000)	(7,550,000)
	13,000	-	-	-	18,000

Gain on sale of property, plant and equipment					
Operating income (loss)	1,791,000	1,341,000	1,717,000	4,143,000	(5,491,000)
Gain on sale of intangible assets	1,990,000	-	-	-	-
Other (expense) income	(339,000)	(513,000)	(637,000)	(54,000)	197,000
Income (loss) before income taxes	3,442,000	828,000	1,080,000	4,089,000	(5,294,000)
Income tax (expense) benefit	(920,000)	(436,000)	(455,000)	172,000	(33,000)
Net income (loss)	$2,522,000	$392,000	$625,000	$4,261,000	$(5,327,000)
Basic earnings (loss) per share	$0.67	$0.10	$0.17	$1.15	$(1.48)
Fully diluted earnings (loss) per share	$0.62	$0.10	$0.15	$1.09	$(1.48)
Total assets	$23,324,000	$23,035,000	$23,678,000	$21,476,000	$17,761,000
Long-term debt (1)	$5,177,000	$8,143,000	$8,553,000	$7,933,000	$6,022,000

(1) Long-term debt is defined as all outstanding long-term debt and capital leases, including current maturities, and the revolving credit facility.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

EXPLANATORY NOTE

Management's Discussion and Analysis of Results of Operations and Financial Condition ("MD&A") is provided to help provide an understanding of our business, financial condition, changes in financial condition and results of operations. The following should be read in conjunction with our Consolidated Financial Statements and Notes included elsewhere in this report. Our MD&A is organized as follows:

Overview. This section contains trend analysis, a summary of the challenges we encountered this fiscal year and steps we are taking to address these challenges. This section may contain forward-looking statements. These statements are based on our current expectations and actual results may materially differ from such expectations. Among the factors that could cause actual results to vary are those described in this "Overview" section and in "Item 1A. Risk Factors."

Results of Operations. This section provides an analysis of results of operations for the two fiscal years presented in the accompanying Consolidated Financial Statements and Notes.

Liquidity and Capital Resources. This section provides an analysis of cash flows, a discussion of outstanding debt, working capital and capital expenditures, and commitments, both firm and contingent, that existed as of January 31, 2013, and trends, demands, events and uncertainties with respect to our ability to finance our continuing operations.

Critical Accounting Policies. This section discusses the accounting policies (i) that require us to make estimates that are highly uncertain at the time the estimate is made, (ii) for which a different estimate which could have been made would have a material impact on our consolidated financial statements, (iii) that are the most important and pervasive policies utilized, and (iv) that are the most sensitive to material change from external factors.

OVERVIEW

We design and manufacture aircraft instrumentation and sensor systems. These products are used for data collection and display of both primary and standby flight data. Display products are the instruments in the cockpit of an aircraft that provide the pilot with primary and standby information about the flight situation of the aircraft, such as altitude, speed and direction. As cockpit panel space becomes more valuable in the new age of glass displays, we have

maintained a strong position with Original Equipment Manufacturers (OEM) as a premier supplier of quality aircraft instrumentation in both the military and commercial aircraft marketplace. We are enhancing this position with the introduction of the digital OASIS® backup display system.

Our air data collection products include a range of conic probes (e.g., AoA, SWT and IMFP®), flush port probes as well as the air data unit within the OASIS® backup system that can be used independently of the OASIS® display unit for use with other digital display systems. We continue to expand the range of aircraft using our air data systems which now include a growing number of UAV's and next generation fighter aircraft.

This wide range of products allows us to offer multiple solutions for air data collection as well as primary and standby displays and backup instrumentation which allow our aircraft manufacturer customers to reduce their number of suppliers. Our unique capabilities in air data collection products continue to expand with the development of multiple air data system designs for domestic and international customers, including highly advanced contour flushport systems as well as new variants of our legacy probe designs. These technologies support manned aircraft and the expanding Unmanned Aerial Vehicle (UAV) markets. During fiscal years 2013 and 2012, we were awarded development contracts to modify or extend air data capabilities for products on existing airframes using these technologies.

Building on our expertise with mechanical instrumentation, we have successfully developed and marketed digital instrumentation and displays for standby redundant systems to complement our mechanical product line.

Our current market focus has been, and will continue to be, the design, development and supply of electronic and mechanical primary and standby flight control systems components and instruments. These include altimeters, airspeed indicators, angle of attack indicators, stall warning systems, air data measurement systems and standby flight display systems. These products are critical to aircraft operation, performance and safety.

In conjunction with our development and production activities, we have developed expertise in the building, testing and validation of critical test equipment, including environmental stress screening chambers and wind tunnels. We are expanding that knowledge to offer customers the ability to order turnkey solutions for their test needs.

The trend in the aerospace industry continues toward digital cockpits and away from mechanical cockpit instrumentation that was our foundation. During fiscal year 2013, we continued to make progress in our ability to design and manufacture digital instrumentation that is integrated into cockpit flight management systems. We maintained and strengthened our commitment to research and development to further enhance our product line as we anticipate continued movement toward digital cockpits in the aerospace industry. Our new OASIS® multi-function standby display is being promoted in support of this trend. We plan to position ourselves such that we continue to offer both digital and mechanical instrumentation solutions to our customers. While we believe that this strategy will, over time, strengthen our position in the aerospace industry, we cannot guarantee that this strategy will be successful or that we will have access to the capital resources needed to fully support this strategy.

A significant amount of our business relates to the sale of our products, services and support to United States (“U.S.”) and foreign military programs. As a consequence, our sales can fluctuate materially, either favorably or unfavorably, depending upon the level of government spending on those military programs which are a major focus of our manufacturing efforts. While we have been successful in obtaining contracts to supply military needs in recent years, sudden reductions in government spending or delays in the government contract award process could have a material unfavorable effect on our current and future military sales and related cash flow. While we cannot predict the outcome of the U.S. government contract award or budget process, we expect that the majority of the military programs that we supply will be sustained at current or near current levels. Additionally, U.S. government procurement offices often require long periods of time to issue requests for proposals and to negotiate contracts. Such lengthy contract cycle times may delay the award of certain anticipated contracts of significant value to the Company. Delays of significant contract awards may have an adverse effect on the financial results of the Company.

In August 2011, the Budget Control Act reduced the U.S. DoD top line budget by approximately $490 billion through 2021. In addition, U.S. government expenditures are subject to the potential for further reductions, generally referred to as "sequestration". Sequestration would result in additional reductions of approximately $500 billion from the defense top line budget through 2021. The Office of Management and Budget (OMB) has estimated that sequestration

would reduce non-exempt defense discretionary accounts during U.S. government fiscal year 2013 by approximately 9.4% (excluding military personnel accounts). The OMB has further stated that the budget for Overseas Contingency Operations and any unobligated balances in prior year funds would be included in aggregate reductions but has otherwise indicated that it cannot yet assess the impact of sequestration at the program, project and activity level. The U.S. DoD has indicated that such reductions might require the termination of certain, as yet undetermined, procurement programs, and other U.S. government customers, such as NASA and various intelligence agencies, may be required to take comparable actions. Any such impacts could have a material effect on our results of operations, financial position and/or cash flows. With the aforementioned fiscal challenges as a backdrop, the U.S. DoD announced a significant revision to the defense strategy in January 2012. This new strategy prioritized the Asia Pacific and Middle East regions, reduced the number of ground forces, maintained nuclear deterrence and reduced Cold War assets. Additionally, it emphasized the increasing importance of Command, Control, Communications, Computers, Intelligence, Surveillance, and Reconnaissance (C4ISR); Cyber Security; Space; Special Operations; and Unmanned Systems in implementing the nation's security posture. We have been developing organic capabilities to better serve our customers and their emerging needs in these markets, including the continued R&D efforts on both our flush port and legacy probe air data technologies.

Similarly, changes in the commercial sector of the aerospace industry can have a favorable or unfavorable impact on our future business. While we have historically invested heavily in product development for both funded and unfunded programs, OEM requirements may change such that additional product development efforts will be necessary to maintain or increase our revenue in the aerospace industry. With respect to ongoing contracts, several of our commercial customers continue to operate with reduced operations and manufacturing. While this may be offset by additional increases in aftermarket support, it is likely that our business will continue to be negatively affected until the economy recovers and our customers resume prior levels of production and growth. The recession in the general aviation and business jet markets has continued longer than previously expected and significant improvement is not forecasted for at least another year. Continued reductions of customer deliveries may have a significant adverse effect on our financial results.

Recognizing the risks and challenges of the current environment in both our military and commercial markets, we continue to closely monitor our operations and cost structure for opportunities to enhance our financial performance in the face of a difficult economic environment. We will continue to pursue actions we deem appropriate to counter the near-term challenges in our markets while preserving our ability to be responsive to our customers as the economy improves.

RESULTS OF OPERATIONS

Our senior management regularly reviews the performance of our operations including reviews of key performance metrics and the status of operating initiatives. We review information on the financial performance of the operations, new business opportunities, customer relationships and initiatives, independent research and development (IR&D) activities, human resources, manufacturing effectiveness, cost reduction activities, as well as other subjects. We compare performance against budget, against prior comparable periods and against our most recent internal forecasts. We do not expect the impact of inflation and changing prices on net sales and income from continuing operations to be material.

While we believe the prospects for our financial performance to be very good over the long term, we continue to work our way through short-term challenges which may cause our financial results to vary on a quarterly basis. Our backlog of firm orders, not including options, as of January 31, 2013 is $30.3 million, an increase of $4.8 million, when compared to the $25.5 million backlog as of January 31, 2012.

Our ability to enhance gross profit and operating results will require that we introduce new products and grow our business while continuing to improve manufacturing throughput and delivery performance. We are well engaged in implementing lean manufacturing principles, supported by training programs, to further develop a consistent, disciplined, and innovative engineering and production culture. We complement these initiatives with a marketing and sales strategy that builds on our market presence and core competencies in sensor, air data computation, and display technologies.

We believe that our recent and planned future investments in support of our customers will produce strong returns as our markets continue their recovery. Because of our improved operating metrics, as well as direct customer feedback with respect to quality and delivery performance, we are far better positioned to win new business. We believe that our improved systems, focused value-stream teams, and growing capabilities will enable us to far more reliably fulfill commitments to our customers, suppliers, and stockholders.

Fiscal year 2013 compared to fiscal year 2012

Net sales were $31,021,000 during fiscal year 2013, an increase of $1,414,000, or 4.8%, compared to $29,607,000 for fiscal year 2012. During fiscal year 2013, our sales volume increased from the prior year by approximately $2.2 million on increased demand for repairs, sensors, spares and development services, offset by approximately $0.8 million on reduced demand for mechanical instruments. Our net sales continue to be impacted by the ongoing recession in the business jet and general aviation markets.

As a percent of sales, gross profit for fiscal year 2013 was 38.5% versus 28.7% for fiscal year 2012. The increase in gross profit in fiscal year 2013, as a percent of sales, reflects (a) increased variable margin due to the higher sales volume, (b) an increase in repairs and spares as a percentage of the overall sales dollar volume in the period, (c) favorable pricing on certain customer orders, particularly in spares and repairs, (d) the positive impact of quality improvements and investments in lean activities over the past two years, and (e) the unfavorable impact in the prior year of costs associated with the transition of the Virginia repair station to our Florida facility.

Selling, general and administrative expenses (SG&A) for fiscal year 2013 were $10,152,000, an increase of $2,998,000 compared to $7,154,000 in fiscal year 2012. The net increase was driven primarily by $2.4 million of increased independent research and development costs, most significantly relating to the OASIS® product. In addition, we incurred increased compensation costs and outside services costs, which were partially offset by lower business development costs.

Interest expense, net decreased to $258,000 in fiscal year 2013 from $371,000 in fiscal year 2012, primarily due to lower interest expense on reduced debt levels.

The Company recognized a $1,990,000 non-recurring gain on sale of intangible assets in the fourth quarter of fiscal year 2013 relating to the sale of certain intellectual property to an international manufacturer. Because of its presentation in Other Income, this sale did not impact gross profit. With the renewal of the BMO Credit Facility prior to maturity, we reported a loss on early extinguishment of debt in fiscal year 2013 of $9,000. In fiscal year 2012, due to the early settlement of the Notes Payable we reported a loss on early extinguishment of debt of $25,000.

Income before taxes was $3,442,000 in fiscal year 2013, compared to income before taxes of $828,000 in fiscal year 2012. The increase of $2,614,000 was primarily due to the gain on sale of intangibles, improved operating income and lower interest expenses.

Income tax expense was $920,000 in fiscal year 2013 compared to income tax expense of $436,000 in fiscal year 2012. The effective tax rate of 26.6% in fiscal year 2013 was lower than the effective tax rate of 52.7% in fiscal year 2012 due primarily to the fiscal year 2013 benefit of a research and development tax credit as well as fiscal year 2012 permanent differences. See Note 11 of "Notes to Consolidated Financial Statements".

For fiscal year 2013, our net income was approximately $2,522,000, or $0.67 basic and $0.62 diluted income per share, compared to net income of approximately $392,000, or $0.10 basic and diluted income per share for fiscal year 2012. The higher income per share amounts were driven by the higher income before taxes combined with the lower effective tax rate in fiscal 2013.

LIQUIDITY AND CAPITAL RESOURCES

Our principal sources of capital have been cash flows from operations and borrowings under our Credit Facility, described below. As of January 31, 2013, we had approximately $0 in cash and cash equivalents, compared to approximately $157,000 as of January 31, 2012. In addition, as of January 31, 2013 and 2012, we had $3,097,000 and $888,000, respectively, available under the Credit Facility.

Our cash provided by operating activities was $2,194,000 for fiscal year 2013, an increase in cash provided of $670,000 compared to cash provided of $1,524,000 for fiscal year 2012. This net increase in cash provided by operating activities is primarily attributable to increases in cash provided by operating activities of:

- $2,130,000 from increased operating net income in fiscal year 2013 of $2,522,000 when compared to operating net income in fiscal year 2012 of $392,000,
- $1,669,000 from advanced customer payments presented as deferred revenue at January 31, 2013,
- $1,133,000 as presented by decreased accrued expenses and other liabilities at January 31, 2013 of $860,000, due primarily to the release of accrued contract losses related to completed engineering contracts in fiscal year 2013, when compared to the change in accrued expenses and other liabilities at January 31, 2012 of $1,993,000, due primarily to the accrual of contract losses related to engineering contracts in process in fiscal year 2012 and
- $683,000 for increased accrued compensation and benefits of $521,000 as of January 31, 2013 when compared to decreased accrued compensation and benefits of $162,000 as of January 31, 2012;

Partially offset by increases in cash used in operating activities of:

- $2,004,000 as presented by increased inventory at January 31, 2013 of $1,544,000 when compared to decreased inventory levels of $460,000 at January 31, 2012,
- $1,990,000 due to the fiscal year 2013 gain on sale of intangible assets,
- $1,087,000 as presented by fiscal year 2013 provisions for contract losses of $187,000 when compared to fiscal year 2012 provisions for contract losses of $1,274,000 and
- $757,000 from the fiscal year 2013 pay down of accounts payable of $873,000 when compared to the fiscal year 2012 pay down of accounts payable of $116,000.

Our cash provided by investing activities in fiscal year 2013 of $615,000 consisted primarily of proceeds from the sale of intangible property of $1,382,000 less capital improvements and equipment of $780,000. In fiscal year 2012, cash used in investing activities amounted to $1,068,000 for capital improvements and equipment.

Our cash used in financing activities for fiscal years 2013 and 2012 was $2,966,000 and $461,000, respectively, resulting in an increase to cash used in financing activities of $2,505,000. The change was attributable to a $3,105,000 fiscal year 2013 net pay down of our Credit Facility, offset by a $600,000 fiscal year 2012 net pay off of the Investors' Notes Payable described below.

Our days sales in accounts receivable remained at 64 days at January 31, 2013, unchanged from January 31, 2012. Through consistent operating income, advance customer payments and the sale of our intellectual property, our

outstanding balances with vendors and suppliers declined as days purchases in accounts payable decreased to 26 days at January 31, 2013, down from 41 days at January 31, 2012.

Our liquidity will depend on our ability to continue to achieve improved operating results and contain costs related to the development of new products. Sufficient liquidity is necessary to, among other things, (i) satisfy working capital requirements, (ii) fulfill necessary capital spending, and (iii) meet our debt obligations in fiscal year 2014 and beyond. A fiscal year 2013 cash advances from a customer, presented as deferred revenue of $1,669,000 as of January 31, 2013, improved our cash flow from operations as presented on our statement of cash flows for the year ended January 31, 2013. Our failure to improve our operating results could have a material adverse effect on our liquidity and could require the implementation of curative measures, including raising capital, deferring planned capital expenditures and research and development efforts, reductions in force, reducing discretionary spending, and selling assets. There can be no assurance that our proposed plans and actions will be successful or that unforeseen circumstances will not require us to seek additional funding sources in the future or effectuate additional plans to conserve liquidity. In addition, there can be no assurance that in the event additional sources of funds are needed, they will be available on acceptable terms, if at all.

Note Payable and BMO Harris Bank Credit Facility

On May 14, 2009, we entered into unsecured notes payable arrangements with three investors allowing us to borrow up to an aggregate of $2,000,000. We completed repayment of the outstanding balance of these notes payable in the first quarter of fiscal year 2012. See Note 7 of “Notes to Consolidated Financial Statements”.

We are party to a Loan Agreement (the “Loan Agreement”) with BMO Harris Bank (the “Lender”) with a maximum amount of credit facilities (the “Credit Facility”) available to us of $10,100,000. The Loan Agreement provides for (a) a $4,000,000 revolving line of credit, pursuant to a revolving line of credit note in the original principal amount of up to $4,000,000 (the “Revolving Credit Line Note”), (b) a $3,500,000 first real estate mortgage loan, (c) a $1,900,000 term loan and (d) a $700,000 equipment line of credit. The Credit Facility is secured by substantially all of our assets. See Note 9 of “Notes to Consolidated Financial Statements”.

The Credit Facility is secured by substantially all assets of the Company. Details of the Credit Facility are as follows:

- The Amended and Restated Revolving Credit Line Note provides a line of credit in an amount equal to the lesser of (a) the Revolving Credit Limit of $4,000,000; or (b) a Borrowing Base determined based on eligible accounts receivable and inventory. Interest is paid monthly. The interest rate on the Amended and Restated Revolving Credit Line Note is one-month LIBOR (which was 0.2087% at January 31, 2013) plus 300 basis points. Available borrowings on the Amended and Restated Revolving Credit Line Note at January 31, 2013 were $3,097,000.
- The Real Estate Mortgage Note, which supports a $3,500,000 first real estate mortgage loan, has a three-year term, a 15-year amortization period, and the interest rate is one-month LIBOR plus 340 basis points with a 4% floor. Interest and principal are paid monthly. The proceeds of the Real Estate Mortgage Note were used for refinancing an existing loan relating to the Clearwater, Florida property and for working capital and capital expenditure needs.
- The Equipment Term Note, which supports a $1,900,000 term loan, has a three-year term, a five-year amortization period, and the interest rate is one-month LIBOR plus 340 basis points with a 4% floor. Interest and principal are paid monthly. The proceeds of the Equipment Term Note were used for refinancing an existing loan relating to the Earlysville, Virginia property and for working capital and capital expenditure needs. The Company must pay any proceeds from the sale of the Earlysville, Virginia property to BMO Harris Bank to be applied as a principal payment under the Equipment Term Note.
- The Equipment Credit Line Note, which supports a $700,000 equipment line of credit, has a three-year term, a five-year amortization period, and the interest rate is one-month LIBOR plus 325 basis points with a 4% floor. Interest is paid monthly. Principal payments began October 2011. Proceeds are used to purchase equipment for use in the Company’s business. The Equipment Credit Line Note matures on May 1, 2014.

The Credit Facility contains certain financial and other restrictive covenants, including the requirement to maintain: (i) minimum Total Stockholders’ Equity; (ii) a ratio of Funded Debt to EBITDA; and (iii) a Fixed Charge Coverage Ratio. See Note 9 of “Notes to Consolidated Financial Statements”.

On January 31, 2013, we entered into an amendment (the “Third Amendment”) to the Loan Agreement. The Amendment (a) renews to January 31, 2016, the maturity date of the Amended and Restated Revolving Credit Line Note in the amount of $4 million; (b) renews to May 1, 2015, the maturity date of the Equipment Term Note in the amount of $887,000, and (c) renews to January 31, 2018, the maturity date of the Real Estate Mortgage Note in the approximate amount of $2,877,000. Except as amended to extend their respective maturities, the new notes contain the same terms and conditions as the promissory notes that they replace.

We were in compliance with all covenants within the Credit Facility as of and for the fiscal year ended January 31, 2013.

Working Capital and Capital Expenditures

Our working capital at January 31, 2013 was $9,084,000 compared to $9,296,000 at January 31, 2012. This decrease in working capital of $212,000 as of January 31, 2013 relates, in part, to a $1,669,000 customer advance, presented in deferred revenue, a decrease in prepaid expenses and other assets of $1,220,000, due primarily to released deferred charges on completed engineering contracts and an increase in accrued compensation and benefits of $521,000. These unfavorable changes to working capital are offset, in part, by favorable changes to working capital resulting from an increase in inventory of $1,402,000, a decrease in accrued expenses and other liabilities of $1,167,000, due primarily to the release of contract loss provisions related to completed engineering contracts and a decrease to accounts payable of $873,000. The collection of our accounts receivable is the primary source of cash used to fund our operations. Our banking line of credit is used as an additional source of cash as necessary from time to time, and we sweep any excess cash back against the line of credit on a daily basis to minimize interest expense. We believe that cash collected from our accounts receivable, as further supplemented by advances under our Credit Facility, are adequate to fund our ongoing operations for the next twelve months. On January 31, 2013, prior to the June 27, 2013 maturity date of the Amended and Restated Revolving Credit Line Note and the May 1, 2013 maturity date of both the Real Estate Mortgage Note and the Equipment Term Note, we renewed and replaced said notes with BMO Harris Bank. Prior to the maturity of the Equipment Credit Line Note of May 1, 2014, we intend on refinancing or renewing said note with BMO Harris Bank. However, there can be no assurance that we will achieve our expected operating results and/or have access to and/or renew or refinance our Credit Facility, or that unforeseen circumstances will not require us to seek additional funding sources in the future. In addition, there can be no assurance that in the event additional sources of funds are needed, they will be available on acceptable terms, if at all.

Our future capital requirements depend on numerous factors, including research and development, expansion of product lines and other factors. Furthermore, we may need to develop and introduce new or enhanced products, respond to competitive pressures, invest or acquire businesses or technologies or respond to unanticipated requirements or developments, which would require additional resources. Currently, our cash flow from operations alone may not be sufficient to meet these challenges.

Our capital expenditures for fiscal year 2013 were $780,000, compared to $1,068,000 for fiscal year 2012. Historically, our capital budget was intended to replace fixed asset equipment as needed and to take advantage of technological improvements that would improve productivity. We continued to replace certain critical fixtures, environmental test chambers and testing equipment that we lost in the August, 2008 fire during fiscal years 2013 and 2012. Additionally, we continue to renovate and reconfigure our Florida production facility to accommodate equipment previously located in our building destroyed in the fire.

Inflation and Changing Prices

Our profitability is dependent, among other things, on our ability to anticipate and react to changes in the cost of key operating resources, including labor and raw materials. Substantial increases in cost of sales and expenses could impact our operating results to the extent that such increases cannot be passed along to customers. While we are taking steps to mitigate our risk to rising prices with prudent purchasing practices and improving our inventory management techniques, there can be no assurance that future supplies of raw materials and labor will not fluctuate due to market conditions outside of our control.

Certain operating costs such as taxes, insurance and other outside services continue to increase at or above the general rate of inflation, and we may be subject to other cost and supply fluctuations outside of our control.

Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements as of January 31, 2013.

Contractual Obligations

The following table presents estimated cash requirements for contractual obligations outstanding as of January 31, 2013.

	Payments Due By Period				
	Less Than One Year	One Year to 3 Years	Greater Than 3 Years to 5 Years	After 5 Years	Total
Purchase commitments	$5,681,000	$411,000	$ -	$ -	$6,092,000
Long-term debt	763,000	1,333,000	2,178,000	-	4,274,000
Revolving credit facility	-	903,000	-	-	903,000
Total contractual obligations	$6,444,000	$2,647,000	$ 2,178,000	$ -	$11,269,000

Environmental Matters

In preparation for the sale of the Earlysville, Virginia facility, we engaged an environmental consulting firm to survey the property for any possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents by a former owner of the property. During fiscal year 2013, we signed an administrative order on consent with the U.S. Environmental Protection Agency to provide the former owner with access to the property and the former owner of the property signed an administrative order on consent with the U.S. Environmental Protection Agency for completion of a contamination characterization study. As a result of the initial and subsequent surveys, our responsibility for the remaining contamination treatment, future monitoring, oversight and other related costs is estimated at $404,000 as of January 31, 2013. We have capitalized these costs as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility and will not result in a carrying value in excess of the estimated fair value less cost to sell. Costs incurred during fiscal year 2013 totaled $22,000 and costs incurred during the fiscal year ended January 31, 2012 totaled $20,000. At this time, we cannot predict how much, if any, we will incur for more costs in fiscal year 2014.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based upon the accompanying consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP"). The preparation of those consolidated financial statements and this Annual Report on Form 10-K requires us to make estimates and judgments that affect the reported amount of assets and liabilities, revenues and expenses, and related disclosure items, including disclosure of contingent assets and

liabilities, at the date of our consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions, and as a result of trends and uncertainties identified above under “Results of Operations” and “Liquidity and Capital Resources” and in “Item 1A. Risk Factors”. Further, such differences could be material.

Set forth below is a discussion of our critical accounting policies. We consider critical accounting policies to be those (i) that require us to make estimates that are highly uncertain at the time the estimate is made, (ii) for which a different estimate which could have been made would have a material impact on our consolidated financial statements, (iii) that are the most important and pervasive policies utilized, and (iv) that are the most sensitive to material change from external factors. Additionally, the policies discussed below are critical to an understanding of the consolidated financial statements because their application places the most significant demands on our judgment, with financial reporting results relying on estimates about the effect of matters that are highly uncertain. Specific risks for these critical accounting policies are described in the following paragraphs. The impact and any associated risks related to these policies on business operations is discussed throughout this MD&A where such policies affect reported and expected financial results.

For a detailed discussion regarding the application of these and other accounting policies, see Note 1 of "Notes to Consolidated Financial Statements." We have discussed the development and selection of the critical accounting estimates and the related disclosure included herein with the Audit Committee of the Board of Directors.

Revenue Recognition

The Company generally recognizes revenue from sales of its products when the following have occurred: evidence of a sale arrangement exists; delivery or shipment has occurred or services have been rendered; the price to the buyer is fixed or determinable; and collectability is reasonably assured.

For fixed-price contracts, the Company may recognize revenue on a Multiple-Elements Arrangement basis. The Multiple-Elements Arrangement method requires the Company to evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting. The Company makes that determination at the inception of the arrangement. In an arrangement with multiple deliverables, the delivered item(s) shall be considered a separate unit of accounting if (a) the delivered item(s) have value to the customer on a standalone basis, (b) there is objective and reliable evidence of the fair value of the undelivered item(s) and (c) the arrangement includes a general right of return relative to the delivered item(s) and delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor. The Company may also recognize its revenue under the completed contract method.

For long-term, fixed-price contracts meeting certain criteria, the Company may elect to follow the percentage-of-completion method of accounting for revenue recognition. Under this method, contract revenue is computed as that percentage of estimated total revenue that costs incurred to date bear to total estimated costs, after giving effect to the most recent estimates of costs to complete. From time to time, the Company will record costs and estimated profits in excess of billings for a contract. Revisions in costs and revenue estimates are reflected in the period in which the revisions are determined. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined without regard to the percentage-of-completion.

Periodically, the Company enters into research and development contracts with customers. When the contracts provide for milestone or other interim payments, the Company will recognize revenue either under the Milestone method or the Multiple-Elements Arrangement method. The Milestone method requires the Company to deem all milestone payments within each contract as either substantive or non-substantive. That conclusion is determined based upon a thorough review of each contract and the Company's deliverables committed to in each contract. For substantive milestones, the Company concludes that upon achievement of each milestone, the amount of the corresponding defined payment is commensurate with the effort required to achieve such milestone or the value of the delivered item. The payment associated with each milestone relates solely to past performance and is deemed reasonable upon consideration of the deliverables and the payment terms within the contract. For non-substantive milestones, including advance payments, the recognition of such payments are pro-rated to the substantive milestones.

Milestones may include, for example, the successful completion of design review or technical review, the submission and acceptance of technical drawings, delivery of hardware, software, spares, test equipment or regulatory agency certifications.

Accounts Receivable, Allowance for Doubtful Accounts and Credit Losses

We continuously evaluate our customers and provide reserves for anticipated credit losses as soon as collection becomes compromised. While credit losses have historically been within expectations of the provisions established, we cannot guarantee that we will continue to experience the same credit loss rates that have been experienced in the past. Measurement of such losses requires consideration of historical loss experience, including the need to adjust for current conditions, and judgments about the probable effects of relevant observable data, including present economic conditions such as delinquency rates and financial health of specific customers.

Inventories

The Company values inventory at standard cost which generally reflects the most recent significant cost for manufactured or purchased inventory. Standards are revalued from time to time to reflect the lower of cost (using a method that approximates the first-in, first-out method "FIFO") or net realizable value. The reserve for obsolete and slow moving inventory is based upon reviews of inventory quantities on hand, usage and sales history.

Work In Process Inventories

We employ certain methods to estimate the value of work in process inventories for financial reporting purposes. Our practice has been to conduct cycle counts of inventory throughout the year. Generally, for items that are in process at the end of a fiscal year, we will make an estimate during the cycle counting process regarding the percentage of completion of such items in order to accurately reflect costs incurred to date on the production of the items that are still in process. These estimates are affected by the nature of the operation at which the items are located at the time a physical inventory is conducted, and are subject to judgment. This practice was employed for fiscal years 2013 and 2012.

Manufacturing Overhead Cost Application

We establish our inventoriable cost of manufacturing overhead by calculating our overhead costs as a percentage of direct labor and applying that percentage to direct labor that has been charged to inventory on a twelve month rolling average basis. This application percentage is reviewed and adjusted no less than annually.

Deferred Tax Asset Valuation Allowance

We account for income taxes in accordance with U.S. GAAP, which states that deferred tax liabilities and assets are determined based on the difference between the financial statement carrying amounts and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. A valuation allowance is provided against the future benefit of deferred tax assets to the extent it is determined that it is more likely than not that the future tax benefits associated with the deferred tax asset will not be realized.

Property Held for Sale

Property held for sale is reported at the lower of its carrying amount or fair value less cost to sell. Depreciation on property held for sale is discontinued at the time the criteria, established by U.S. GAAP, are met. The Earlysville, Virginia property is presently held for sale. The property consists of a 53,000 square foot manufacturing facility on approximately 12 acres of land. In preparation for the sale of the Earlysville, Virginia facility, we engaged an environmental consulting firm to survey the property for any possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents by a former owner of the property. During fiscal year 2013, we signed an administrative order on consent with the U.S. Environmental Protection Agency to provide the former owner with access to the property and the former owner of the property signed an administrative order on consent with the U.S. Environmental Protection Agency for completion of a contamination characterization study. As a result of the initial and subsequent surveys, our responsibility for the remaining contamination treatment, future monitoring, oversight and other related costs is estimated at $404,000 as of January 31, 2013. We have capitalized these costs as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility and will not result in a carrying value in excess of the estimated fair value less cost to sell. Costs incurred during fiscal year 2013 totaled $22,000 and costs incurred during the fiscal year ended January 31, 2012 totaled $20,000. At this time, we cannot predict how much, if any, we will incur for more costs in fiscal year 2014.

Goodwill and Intangible Assets

The carrying value of goodwill is reviewed at least annually for impairment and will be reviewed more frequently if current events and circumstances indicate a possible impairment. An impairment loss is charged to expense in the period identified. As current events and circumstances warrant, the Company examines the carrying value of its intangible assets with finite lives, such as capitalized software and development costs, purchased intangibles, and other long-lived assets, to determine whether there are any impairment losses. If indicators of impairment are present and future cash flows are not expected to be sufficient to recover the asset's carrying amount, an impairment loss is charged to expense in the period identified. Factors that may cause impairment include negative industry or economic trends or significant underperformance relative to historical or projected future operating results.

Long-Lived Assets

The useful lives of property, plant and equipment for purposes of computing depreciation are:

Land improvements	15-20 Years
Buildings and improvements	25-40 Years
Machinery and equipment	3-15 Years
Patterns, dies, and tools	5-10 Years
Furniture and fixtures	3-10 Years

We periodically evaluate long-lived assets for potential impairment and will record an impairment charge whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. As of January 31, 2013 and January 31, 2012, we do not believe that any assets are impaired.

We will capitalize production costs for computer software that is to be utilized as an integral part of a product when both (a) technological feasibility is established for the software; and (b) all research and development activities for the other components of the product have been completed. Amortization is charged to expense at the greater of the expected unit sales versus units sold or the straight line method for a period of three years from the date the product becomes available for general release to customers.

Income Taxes

The Company and its includable subsidiaries file a consolidated U.S. federal income tax return in accordance with the provisions of the Internal Revenue Code of 1986, as amended.

The Company’s accounting for income taxes represents management’s best estimate of various events and transactions.

Deferred tax assets and liabilities resulting from temporary differences between the financial reporting and tax bases of assets and liabilities are measured at the balance sheet date using enacted tax rates expected to apply to taxable income in the years the temporary differences are expected to reverse.

The realization of deferred tax assets depends upon the existence of sufficient taxable income within the carryback or carryforward periods under the tax law in the applicable tax jurisdiction. Valuation allowances are established when management determines, based on available information, that it is more likely than not that deferred income tax assets will not be realized. Significant judgment is required in determining whether valuation allowances should be established as well as the amount of such allowances. When making such determination, consideration is given to, among other things, the following:

- future taxable income exclusive of reversing temporary differences and carryforwards;
- future reversals of existing taxable temporary differences;
- taxable income in prior carryback years and

·tax planning strategies.

We believe that we will ultimately recover a majority of the deferred tax assets recorded on our consolidated balance sheets. However, should there be a change in our ability to recover our deferred tax assets, our tax provision would increase in the period in which we determined that the recovery was not likely.

We re-evaluate uncertain tax positions on a regular basis. This evaluation is based on factors such as changes in facts or circumstances, changes in tax law, new audit activity, and effectively settled issues. Determining whether an uncertain tax position is effectively settled requires judgment. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision.

The Company classifies tax related interest and tax related penalties as a component of income taxes.

Research and Development

Research and development costs that are not associated with specific customer contract requirements are expensed in the period incurred and are included in selling, general and administrative expenses.

Environmental Expenditures

The Company assesses its property held for sale, along with any property that is being taken out of its initially intended use, for the presence of hazardous or toxic substances that would result in an environmental liability. In addition, management assesses its current property in use for any environmental issues.

Liabilities for environmental remediation costs not related to retirements of tangible long-lived assets, and arising from claims, assessments, litigation, fines, and penalties and other sources, are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

Legal costs incurred in connection with environmental remediation are expensed as incurred. Recoveries of environmental remediation costs from third parties, which are probable of realization, are separately recorded as assets, and are not offset against the related environmental liability, in accordance with U.S. GAAP.

Stock-Based Compensation

The Company adopted the fair value recognition provisions of U.S. GAAP using the modified-prospective-transition method which requires us to recognize compensation expense on a prospective basis. U.S. GAAP requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. Under this method, in addition to reflecting compensation for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro-forma disclosure in prior periods. The stock-based compensation expense is included in selling, general and administrative expenses in the consolidated statements of operations. During the fiscal years ended January 31, 2013 and January 31, 2012, the Company recorded stock-based compensation, including director-fees expense, of $103,000 and $188,000, respectively.

Stock issued in payment for services provided by members of the board of directors is expensed in the period the services are provided. During both fiscal years ended January 31, 2013 and 2012, the Company recorded director-fees expense, through the issuance of stock, of $60,000.

Product Warranties

We provide for the estimated costs of warranties at the time the related revenue is recognized. We estimate the costs based on historical and projected product failure rates and historical and projected repair costs. Warranty terms and conditions vary depending upon the product sold and the customer it was sold to, but generally includes parts and labor over a period generally ranging from one to five years. We regularly reevaluate our estimates to assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.

Use of Estimates

We prepare our consolidated financial statements in conformity with U.S. GAAP. These principles require management to make estimates and judgments that affect reported and contingent amounts of assets, liabilities, revenues and expenses, including such items as (i) inventory, restructuring and environmental costs, (ii) percentage-of-completion estimates, (iii) other miscellaneous accruals and (iv) valuation allowances for accounts receivable, inventory, long-lived assets, property held for sale and deferred tax assets. Actual results may differ from these estimates under different assumptions or conditions, and such differences could be material.

Adoption of New Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board (FASB) amended the guidance on the annual testing of goodwill for impairment. The amended guidance will allow us to assess qualitative factors to determine if it is more-likely-than-not that goodwill might be impaired and whether it is necessary to perform the two-step goodwill impairment test required under current accounting standards. This guidance will be effective for our fiscal year ending January 31, 2013, with early adoption permitted. We have determined that this new guidance will not have a material impact on our consolidated financial statements.

In July 2012, the FASB amended guidance on the annual testing of indefinite-lived intangible assets for impairment. Under the amended guidance, an entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount. This guidance will be effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. We have determined that this new guidance will not have a material impact on our consolidated financial statements.

In February 2013, the FASB issued guidance on the Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income. The guidance requires that companies present either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source (e.g., the release due to cash flow hedges from interest rate contracts) and the income statement line items affected by the reclassification (e.g., interest income or interest expense). If a component is not required to be reclassified to net income in its entirety (e.g., the net periodic pension cost), companies would instead cross reference to the related footnote for additional information (e.g., the pension footnote). This guidance is effective for fiscal and interim reporting periods beginning after December 15, 2012. The adoption of this guidance is not expected to have a material effect on our consolidated financial statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not issue or invest in financial instruments or their derivatives for trading or speculative purposes. Our market risk is limited to fluctuations in interest rates pertaining to our borrowings under our existing debt facilities which require the payment of interest at a variable rate equal to one-month LIBOR plus 300 to 340 basis points. We therefore are exposed to market risk from changes in interest rates on funded debt. Any increase in these rates could adversely affect our interest expense. The extent of market rate risk associated with fluctuations in interest rates is not quantifiable or predictable because of the volatility of future interest rates and business financing requirements. We use no derivative products to hedge or mitigate interest rate risk.

Based on the outstanding balances on our credit facilities as of January 31, 2013, a 1% increase in interest rates would cost us approximately $48,000 annually.

We purchase materials for use in our products based on market prices established with our suppliers. Many of the materials purchased can be subject to volatility due to market supply and demand factors outside of our control. To mitigate this risk, in part, we attempt to enter into fixed-price purchase agreements with reasonable terms.

We have limited market risk exposure to fluctuations in foreign exchange rates as we have a limited number of purchase and sale transactions denominated in British Pounds.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements and supplementary data required by Item 8 are listed in the index beginning on page F-1 and are included in this Form 10-K.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures, as defined in Rules 13a-15(e) and 15(d)-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to Company’s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Evaluation of Disclosure Controls and Procedures as of January 31, 2013

As of the end of the period covered by this report, the Company carried out, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act. Based on that evaluation, the Company's Chief Executive Officer and the Company's Chief Financial Officer have concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective to ensure that all material information required to be included in our reports filed or submitted under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission and (2) accumulated and communicated to the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding disclosure.

Internal Control Over Financial Reporting

(a) Management's Annual Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Exchange Act as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and implemented by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with Generally Accepted Accounting Principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the Company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisitions, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Financial management has documented and evaluated the effectiveness of the internal control of the Company as of January 31, 2013 pertaining to financial reporting in accordance with the criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO").

Based on management's assessment under the framework of the criteria in *Internal Control-Integrated Framework* issued by COSO, management concluded that our internal control over financial reporting was effective as of January 31, 2013.

(b) Changes in Internal Control Over Financial Reporting

Management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the Company's internal control over financial reporting to determine whether any changes occurred during the quarter ended January 31, 2013 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on that evaluation, there have been no changes in the Company's internal control over financial reporting during the quarter ended January 31, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information with respect to Directors and certain Executive Officers required by Item 10 shall be included in the Proxy Statement or an amendment to this Annual Report on Form 10-K and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

Information with respect to executive compensation required by Item 11 shall be included in the Proxy Statement or an amendment to this Annual Report on Form 10-K and is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information with respect to security ownership and the other matters required by Item 12 shall be included in the Proxy Statement or an amendment to this Annual Report on Form 10-K and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS, RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information with respect to certain relationships and related transactions required by Item 13 shall be included in the Proxy Statement or an amendment to this Annual Report on Form 10-K and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Information with respect to principal accountant fees and services required by Item 14 shall be included in the Proxy Statement or an amendment to this Annual Report on Form 10-K and is incorporated herein by reference.

PART IV

ITEM15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

a) The following documents are filed as part of this Annual Report:

1. The financial statements listed in the index to Financial Statements following the signature pages hereof.

2. Exhibits

Exhibit No.	Description of Exhibit
2.1	Agreement and Plan of Merger dated as of April 19, 2013, among Aerosonic Corporation, TransDigm Group Incorporated and Buccaneer Acquisition Sub Inc., incorporated by reference to Exhibit 2.1 of the Company's Current Report on Form 8-K, filed on April 22, 2013.
3.1	Restated Certificate of Incorporation of Instrument Technology Corporation, filed on January 12, 1970, incorporated by reference to Exhibit 3.1 of the Company's Annual Report on Form 10-K for the year ended January 31, 2003, filed on October 31, 2003.
3.2	Certificate of Amendment to the Articles of Incorporation, changing the name Instrument Technology Corporation to Aerosonic Corporation, filed on September 21, 1970, incorporated by reference to Exhibit 3.3 of the Company's Annual Report on Form 10-K for the year ended January 31, 2003, filed on October 31, 2003.
3.3	Certificate of Amendment to the Articles of Incorporation of Aerosonic Corporation, filed on August 6, 1971, incorporated by reference to Exhibit 3.4 of the Company's Annual Report on Form 10-K for the year ended January 31, 2003, filed on October 31, 2003.
3.4	Certificate of Reduction of Capital of Aerosonic Corporation, filed on June 5, 1978, incorporated by reference to Exhibit 3.5 of the Company's Annual Report on Form 10-K for the year ended January 31, 2003, filed on October 31, 2003.
3.5	Certificate of Amendment to Articles of Incorporation of Aerosonic Corporation, filed on February 12, 1993, incorporated by reference to Exhibit 3.6 of the Company's Annual Report on Form 10-K for the year ended January 31, 2003, filed on October 31, 2003.
3.6	Amended and Restated Bylaws of the Company, incorporated by reference to Exhibit 3.8 of the Company's Annual Report on Form 10-K for the year ended January 31, 2005, filed on April 18, 2005.

4.1	Amendment to Aerosonic Corporation 2004 Stock Incentive Plan (as amended and restated on July 26, 2007), incorporated by reference to Appendix A of the Company's Definitive Proxy Statement on Schedule 14A, filed on June 1, 2009.
10.1*	Employment Agreement, dated April 17, 2008, between the Company and Douglas Hillman, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on April 23, 2008.
10.2*	Amended and Restated Employment Agreement, dated November 28, 2005, between the Company and Mark Perkins, incorporated by reference to Exhibit 10.3 of the Company's Quarterly Report on Form 10-Q for the quarter ended October 28, 2005, filed on November 28, 2005.

10.3*	Employment Agreement, dated August 25, 2008, between the Company and Thomas Cason, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on August 25, 2008.
10.4*	Aerosonic Corporation 2004 Stock Incentive Plan (as amended and restated on July 26, 2007), incorporated by reference to Exhibit 4.1 of the Company's Registration Statement on Form S-8, filed on August 31, 2007.
10.5	Share Purchase Agreement, dated August 21, 2007, between the Company, OP Technologies, Inc., Optimization Technologies, Inc. and certain stockholders thereof, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on August 24, 2007.
10.6	Form of Loan Agreement, dated May 14, 2009, between the Company and Investors, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on May 20, 2009.
10.7	Form of 14% Subordinated Note, dated May 14, 2009, between the Company and its wholly-owned subsidiaries, Avionics Specialties, Inc. and OP Technologies, Inc., and Investors incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K, filed on May 20, 2009.
10.8	Form of Warrant Certificate between the Company and Investors, incorporated by reference to Exhibit 10.3 of the Company's Current Report on Form 8-K, filed on May 20, 2009.
10.9*	Employment Agreement, dated May 26, 2009, between the Company and Kevin J. Purcell, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on May 29, 2009.
10.10	$4,000,000 Revolving Line of Credit Note dated as of April 30, 2010 between Aerosonic Corporation and BMO Harris Bank, incorporated by reference to Exhibit 10.28 of the Company's Current Report on Form 10-K, filed on May 3, 2010.
10.11	$3,500,000 Real Estate Term Loan Note dated as of April 30, 2010 between Aerosonic Corporation and BMO Harris Bank, incorporated by reference to Exhibit 10.29 of the Company's Current Report on Form 10-K, filed on May 3, 2010.
10.12	$1,900,000 Equipment Term Loan Note dated as of April 30, 2010 between Aerosonic Corporation and BMO Harris Bank, incorporated by reference to Exhibit 10.30 of the Company's Current Report on Form 10-K, filed on May 3, 2010.
10.13	$700,000 Equipment Line of Credit Note dated as of April 30, 2010 between Aerosonic Corporation and BMO Harris Bank, incorporated by reference to Exhibit 10.31 of the Company's Current Report on Form 10-K, filed on May 3, 2010.
10.14	Security Agreement dated as of April 30, 2010 between the Company and BMO Harris Bank, incorporated by reference to Exhibit 10.32 of the Company's Current Report on Form 10-K, filed on May 3, 2010.
10.15	Mortgage, Security Agreement and Assignment of Rents dated as of April 30, 2010 between the Company and BMO Harris Bank, incorporated by reference to Exhibit 10.33 of the Company's Current Report on Form 10-K, filed on May 3, 2010.

10.16	Guaranty Agreement dated as of April 30, 2010 between the Company and BMO Harris Bank, incorporated by reference to Exhibit 10.35 of the Company's Current Report on Form 10-K, filed on May 3, 2010.
10.17	First Amendment to Loan Agreement dated as of January 10, 2011 between the Company and BMO Harris Bank, incorporated by reference to Exhibit 10.17 of the Company's Current Report on Form 10-K, filed on May 2, 2011.
10.18	Joint Amendment to Loan Agreement and Revolving Line of Credit Note dated as of April 29, 2011 between the Company and BMO Harris Bank, incorporated by reference to Exhibit 10.18 of the Company's Current Report on Form 10-K, filed on May 2, 2011.
10.19	Joint Amendment to Loan Agreement and Revolving Line of Credit Note, dated as of June 27, 2011, between Aerosonic Corporation and BMO Harris Bank, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 10-Q, filed on September 12, 2011.
10.20	Second Amendment to Loan Agreement, dated September 26, 2011, between Aerosonic Corporation and BMO Harris Bank N.A., incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on September 30, 2011.
10.21	Amended and Restated Revolving Line of Credit Note, dated September 26, 2011, between Aerosonic Corporation and BMO Harris Bank N.A., incorporated by reference to Exhibit 10.2 of the Company's Current Report on Form 8-K, filed on September 30, 2011.
10.22	Amendment to Aerosonic Corporation 2012 Summary Compensation Table, as presented within the Company's Definitive Proxy Statement on Schedule 14A, filed on May 30, 2012, incorporated by reference to the Company's Current Report on Form 8-K, filed on June 21, 2012.
10.23	First Amendment to Amended and Restated Revolving Line of Credit Note, dated June 15, 2012, between Aerosonic Corporation and BMO Harris Bank N.A., incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on June 21, 2012.
10.24	Development Collaboration and Intellectual Property Agreement, dated January 21, 2013, between Aerosonic Corporation and LG CNS Co., Ltd.
10.25*	Retention Agreement, dated April 18, 2013, between the Company and Douglas J. Hillman, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on April 22, 2013.
10.26 *	Retention Agreement, dated April 18, 2013, between the Company and Kevin J. Purcell, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on April 22, 2013.
10.27 *	Retention Agreement, dated April 18, 2013, between the Company and Thomas W. Cason, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on April 22, 2013.
10.28 *	Retention Agreement, dated April 18, 2013, between the Company and P. Mark Perkins, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on April 22, 2013.

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10.29 *	Retention Agreement, dated April 18, 2013, between the Company and Scott R. Kempshall, incorporated by reference to Exhibit 10.1 of the Company's Current Report on Form 8-K, filed on April 22, 2013.
21	Subsidiaries of the Registrant, as of January 31, 2013
23.1	Consent of Independent Registered Public Accounting Firm-Mayer Hoffman McCann P.C.
24	Power of Attorney, incorporated into the Signature Page hereto.
31.1	Section 302 Certifications
31.2	Section 302 Certifications
32.1	Section 906 Certifications
32.2	Section 906 Certifications

* Indicates management contract or compensatory plan

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

AEROSONIC CORPORATION
(Registrant)

By: /s/ Douglas J. Hillman Date: May 1, 2013
President and Chief Executive Officer (PEO)

By:/s/ Kevin J. Purcell Date: May 1, 2013
Executive Vice President and Chief Financial Officer (PFO and PAO)

Power of Attorney

Each person whose signature appears below authorizes Douglas J. Hillman to execute in the name of each such person who is then an officer or director of the Registrant and to file any amendments to this annual report on Form 10-K necessary or advisable to enable the Registrant to comply with the Securities Exchange Act of 1934, as amended, and any rules, regulations and requirements of the Securities and Exchange Commission in respect thereof, which amendments may make such changes in such report as such attorney-in-fact may deem appropriate.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/s/ Douglas J. Hillman Date: May 1, 2013

Douglas J. Hillman
President, Chief Executive Officer and Director

/s/ P. Mark Perkins Date: May 1, 2013

P. Mark Perkins
Executive Vice President and Director

/s/ Donald Russell	Date: May 1, 2013
Donald Russell, Director	
/s/ Thomas E. Whytas, Jr.	Date: May 1, 2013
Thomas E. Whytas, Jr., Director	
/s/ Roy Robinson	Date: May 1, 2013
Roy Robinson, Director	

AEROSONIC CORPORATION AND SUBSIDIARIES

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of

Aerosonic Corporation and Subsidiaries:

We have audited the accompanying consolidated balance sheets of Aerosonic Corporation and Subsidiaries (Company) as of January 31, 2013 and 2012, and the related consolidated statements of operations, stockholders' equity and cash flows for the years in the two-year period ended January 31, 2013. The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Aerosonic Corporation and Subsidiaries as of January 31, 2013 and January 31, 2012, and the results of its operations and its cash flow for each of the years in the two-year period ended January 31, 2013 in conformity with accounting principles generally accepted in the United States of America.

/s/ Mayer Hoffman McCann P.C.

Clearwater, Florida

May 1, 2013

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AEROSONIC CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets

January 31, 2013 and 2012

	2013	2012
ASSETS		
Current assets:		
Cash and cash equivalents	$-	$157,000
Accounts receivable, net	5,408,000	5,190,000
Income tax receivable	45,000	-
Inventories, net	8,195,000	6,793,000
Prepaid expenses and other current assets, net	582,000	1,802,000
Deferred income taxes	1,500,000	1,549,000
Total current assets	15,730,000	15,491,000
Property held for sale	1,700,000	2,062,000
Property, plant and equipment, net	4,534,000	4,206,000
Deferred income taxes	292,000	770,000
Intangible assets, net	-	94,000
Goodwill	366,000	366,000
Other assets, net	702,000	46,000
Total assets	$23,324,000	$23,035,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Revolving credit facility	$-	$3,112,000
Current maturities of long-term debt	763,000	753,000
Accounts payable, trade	1,439,000	2,312,000
Compensation and benefits	1,139,000	618,000
Accrued sales commissions	280,000	14,000
Deferred revenue	1,669,000	-
Accrued expenses and other liabilities	1,331,000	2,498,000
Deferred income taxes	25,000	-
Total current liabilities	6,646,000	9,307,000
Revolving credit facility	903,000	-
Long-term debt	3,511,000	4,278,000
Deferred income taxes	224,000	35,000
Total liabilities	11,284,000	13,620,000
Commitments and contingencies (Note 13)		
Stockholders' equity:		
Common stock, $.40 par value: authorized 8,000,000 shares; issued 4,397,252 shares and 4,201,090 shares at January 31, 2013 and 2012, respectively; outstanding 3,966,485 shares and 3,770,323 shares at January 31, 2013 and 2012, respectively.	1,759,000	1,680,000
Additional paid-in capital	6,436,000	6,412,000

Retained earnings	7,008,000	4,486,000
Less treasury stock: 430,767 shares at both January 31, 2013 and 2012, at cost	(3,163,000)	(3,163,000)
Total stockholders' equity	12,040,000	9,415,000
Total liabilities and stockholders' equity	$23,324,000	$23,035,000

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

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AEROSONIC CORPORATION AND SUBSIDIARIES

Consolidated Statements of Operations

For the Years Ended January 31, 2013 and 2012

	2013	2012
Sales, net	$31,021,000	$29,607,000
Cost of sales	19,091,000	21,112,000
Gross profit	11,930,000	8,495,000
Selling, general and administrative expenses	10,152,000	7,154,000
Gain on sale of property, plant and equipment	13,000	-
Operating income	1,791,000	1,341,000
Other (expense) income:		
Interest expense, net	(258,000)	(371,000)
Gain on sale of intangible assets	1,990,000	-
Other expense	(72,000)	(117,000)
Loss on early extinguishment of debt	(9,000)	(25,000)
	1,651,000	(513,000)
Income before income taxes	3,442,000	828,000
Income tax expense	(920,000)	(436,000)
Net income	$2,522,000	$392,000
Basic income per share	$0.67	$0.10
Diluted income per share	$0.62	$0.10
Weighted average shares outstanding basic	3,782,861	3,760,483
Weighted average shares outstanding fully diluted	4,093,525	4,047,016

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

AEROSONIC CORPORATION AND SUBSIDIARIES

Consolidated Statements of Stockholders' Equity

For the Years Ended January 31, 2013 and 2012

	Common Stock Shares Outstanding	Amount	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Total
Balance at January 31, 2011	3,749,472	$1,672,000	$6,232,000	$4,094,000	$(3,163,000)	$8,835,000
Net income	-	-	-	392,000	-	392,000
Directors' equity compensation	19,851	8,000	52,000	-	-	60,000
Exercise of stock options	1,000	-	1,000	-	-	1,000
Stock-based compensation	-	-	127,000	-	-	127,000
Balance at January 31, 2012	3,770,323	1,680,000	6,412,000	4,486,000	(3,163,000)	9,415,000
Net income	-	-	-	2,522,000	-	2,522,000
Directors' equity compensation	18,828	8,000	52,000	-	-	60,000
Exercise of stock options	3,334	1,000	3,000	-	-	4,000
Stock-based compensation	174,000	70,000	(31,000)	-	-	39,000
Balance at January 31, 2013	3,966,485	$1,759,000	$6,436,000	$7,008,000	$(3,163,000)	$12,040,000

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

AEROSONIC CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows

For the Years Ended January 31, 2013 and 2012

	2013	2012
Cash flows from operating activities:		
Net income	$2,522,000	$392,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	451,000	380,000
Amortization	131,000	197,000
Accretion on long-term debt	-	26,000
Loss on early extinguishment of debt	9,000	25,000
Provision for bad debt	196,000	118,000
Provision for obsolete and slow-moving inventory	142,000	110,000
Provision for warranty	87,000	244,000
Provision for contract losses	187,000	1,274,000
Stock-based compensation	103,000	188,000
Gain on sale of intangible assets	(1,990,000)	-
Gain on sale of property, plant & equipment	(13,000)	-
Provision for deferred income taxes	920,000	436,000
Changes in assets and liabilities:		
Accounts receivable, net	(414,000)	(655,000)
Income taxes receivable	(45,000)	-
Inventories, net	(1,544,000)	460,000
Prepaid expenses and other current assets, net	1,220,000	600,000
Other assets	(46,000)	-
Accounts payable, trade	(873,000)	(116,000)
Compensation and benefits	521,000	(162,000)
Deferred revenue	1,669,000	-
Deferred income tax benefit	(179,000)	-
Accrued expenses and other liabilities	(860,000)	(1,993,000)
Net cash provided by operating activities	2,194,000	1,524,000
Cash flows from investing activities:		
Proceeds from sale of intangible assets	1,382,000	-
Proceeds from sale of property, plant & equipment	13,000	-
Capital expenditures	(780,000)	(1,068,000)
Net cash provided by (used in) investing activities	615,000	(1,068,000)
Cash flows from financing activities:		
Net (decrease) increase in revolving credit facility	(2,209,000)	799,000
Principal payments on notes payable	-	(600,000)
Principal payments on long-term debt	(757,000)	(660,000)
Net cash used in financing activities	(2,966,000)	(461,000)

Change in cash and cash equivalents	(157,000)	(5,000)
Cash and cash equivalents, beginning of year	157,000	162,000
Cash and cash equivalents, end of year	$ -	$ 157,000
Supplemental disclosures of cash flow information:		
Net cash paid during the year for:		
Interest	$ 269,000	$ 345,000
Income taxes	$ 53,000	$ -

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

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

1. Description of Business, Basis of Presentation and Summary of Significant Accounting Policies

Description of Business

Aerosonic Corporation ("Aerosonic") and its wholly-owned subsidiaries, Avionics Specialties, Inc. and OP Technologies, Inc. (collectively referred to herein as the "Company") manufacture and sell aircraft instrumentation and sensors systems, including integrated cockpit displays, digital and mechanical standby displays, sensors and probes. Our customers include government and commercial users located worldwide. The Company's production facilities are located in Clearwater, Florida.

Liquidity, Covenant Compliance and Management's Plans

The Company's liquidity will depend on its ability to continue to achieve improved operating results and contain costs related to the development of new products. Sufficient liquidity is necessary to, among other things, (i) satisfy working capital requirements, (ii) fulfill necessary capital spending and (iii) meet the Company's debt obligations in fiscal year 2014 and beyond.

The Company's principal sources of capital have been cash flows from operations and borrowings under its credit facilities (the "Credit Facility") with BMO Harris Bank, N.A. ("BMO Harris Bank"). As more fully described in Note 9, the Company is required to comply with a number of financial and other covenants under the Credit Facility. The Company did not comply with certain financial covenants for the periods ended July 29, 2011 and October 28, 2011. BMO Harris Bank waived non-compliance for these periods and agreed to modify certain financial covenants and other terms of the Credit Facility. However, absent a waiver or modification to the Credit Facility, the Company's failure to comply with these covenants in future periods would constitute a default under the Credit Facility, which would entitle BMO Harris Bank to terminate the Company's ability to borrow under the Credit Facility and accelerate the Company's obligations to repay outstanding borrowings. There can be no assurance that BMO Harris Bank would agree to any future waivers or modifications. The Company, however, was in compliance with all covenants within the Credit Facility as of January 31, 2012 and for all compliance periods within fiscal year 2013.

Failure by the Company to maintain its improved operating results or contain costs related to the development of new products could have a material adverse effect on the Company's liquidity and could require the implementation of

curative measures, including raising capital, deferring planned capital expenditures and research and development efforts, reductions in force, reducing discretionary spending, and selling assets. There can be no assurance that any curative measures proposed by management will be successful to conserve liquidity. In addition, there can be no assurance that in the event additional sources of funds are needed, they will be available on acceptable terms, if at all.

Basis of Presentation

The Company prepares its consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP"). These principles require management to make estimates and judgments that affect reported and contingent amounts of assets, liabilities, revenues and expenses, including such items as (i) inventory, (ii) restructuring and environmental costs, (iii) other miscellaneous accruals and (iv) valuation allowances for accounts receivable, inventory and deferred tax assets (including the measurement of uncertain tax positions). Actual results may differ from these estimates under different assumptions or conditions, and such differences could be material.

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

The accompanying consolidated financial statements include the accounts of the Company. All significant intercompany balances and transactions have been eliminated in consolidation. The Company operates on a fiscal year that ends on January 31, consisting of four quarters, each of the first three quarters ending on the Friday of each successive 13 week period. Accordingly, all references to the third quarter mean the third quarter ended on the 39th Friday of the fiscal year. For example, references to the third quarter of fiscal year 2013 mean the quarter ended October 26, 2012.

Reclassifications

Certain amounts in the fiscal year 2012 financial statements have been reclassified to conform to the fiscal year 2013 presentation. Such reclassifications had no effect on net loss or stockholders' equity as previously reported.

Accounts Receivable, Allowance for Doubtful Accounts and Credit Losses

The Company continuously evaluates our customers and provides reserves for anticipated credit losses as soon as collection becomes compromised. While credit losses have historically been within expectations of the provisions established, the Company cannot guarantee that it will continue to experience the same credit loss rates that have been experienced in the past. Measurement of such losses requires consideration of historical loss experience, including the need to adjust for current conditions, and judgments about the probable effects of relevant observable data, including present economic conditions such as delinquency rates and financial health of specific customers.

Inventories

The Company values inventory at standard cost which generally reflects the most recent significant cost for manufactured or purchased inventory. Standards are revalued from time to time to reflect the lower of cost (using a method that approximates the first-in, first-out method "FIFO") or net realizable value. The reserve for obsolete and slow moving inventory is based upon reviews of inventory quantities on hand, usage and sales history.

Work In Process Inventories

The Company employs certain methods to estimate the value of work in process inventories for financial reporting purposes. The Company's practice has been to conduct cycle counts of inventory throughout the year. Generally, for items that are in process at the end of a fiscal year, the Company will make an estimate during the cycle counting process regarding the percentage of completion of such items in order to accurately reflect costs incurred to date on the production of the items that are still in process. These estimates are affected by the nature of the operation at which the items are located at the time a physical inventory is conducted, and are subject to judgment. This practice was employed for fiscal years 2013 and 2012.

Manufacturing Overhead Cost Application

The Company establishes its inventoriable cost of manufacturing overhead by calculating overhead costs as a percentage of direct labor and applying that percentage to direct labor that has been charged to inventory on a twelve month rolling average basis. This application percentage is reviewed and adjusted no less than annually.

Deferred Tax Asset Valuation Allowance

The Company accounts for income taxes in accordance with U.S. GAAP, which states that deferred tax liabilities and assets are determined based on the difference between the financial statement carrying amounts and tax bases of assets and liabilities using enacted tax rates in effect in the years in which the differences are expected to reverse. A valuation allowance is provided against the future benefit of deferred tax assets to the extent it is determined that it is more likely than not that the future tax benefits associated with the deferred tax asset will not be realized.

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

Property Held for Sale

Property held for sale is reported at the lower of its carrying amount or fair value less cost to sell. Depreciation on property held for sale is discontinued at the time the criteria, established by U.S. GAAP, are met. The Earlysville, Virginia property is presently held for sale. The property consists of a 53,000 square foot manufacturing facility on approximately 12 acres of land. In preparation for the sale of the Earlysville, Virginia facility, the Company engaged an environmental consulting firm to survey the property for any possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents by a former owner of the property. During fiscal year 2013, the Company signed an administrative order on consent with the U.S. Environmental Protection Agency to provide the former owner with access to the property and the former owner of the property signed an administrative order on consent with the U.S. Environmental Protection Agency for completion of a contamination characterization study. As a result of the initial and subsequent surveys, the Company's responsibility for the remaining contamination treatment, future monitoring, oversight and other related costs is estimated at $404,000 as of January 31, 2013. The Company has capitalized these costs as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility and will not result in a carrying value in excess of the estimated fair value less cost to sell. Costs incurred during fiscal year 2013 totaled $22,000 and costs incurred during the fiscal year ended January 31, 2012 totaled $20,000. At this time, the Company cannot predict how much, if any, it will incur for more costs in fiscal year 2014.

Property, Plant and Equipment

Property, plant and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on the straight-line method over the estimated useful lives of the assets. Upon disposition, the cost and related accumulated depreciation are removed from the accounts and any related gain or loss is included in earnings. Expenditures for repairs and improvements that significantly add to the productive capacity or extend the useful life of an asset are capitalized. Repair and maintenance charges are expensed as incurred.

The useful lives of property, plant and equipment for purposes of computing depreciation are:

Land improvements	15-20 Years
Buildings and improvements	25-40 Years
Machinery and equipment	3-15 Years

Patterns, dies and tools	5-10 Years
Furniture and fixtures	3-10 Years

Goodwill and Intangible Assets

The carrying value of goodwill is reviewed at least annually for impairment and will be reviewed more frequently if current events and circumstances indicate a possible impairment. An impairment loss is charged to expense in the period identified. As current events and circumstances warrant, the Company examines the carrying value of its intangible assets with finite lives, such as capitalized software and development costs, purchased intangibles, and other long-lived assets, to determine whether there are any impairment losses. If indicators of impairment are present and future cash flows are not expected to be sufficient to recover the asset's carrying amount, an impairment loss is charged to expense in the period identified. Factors that may cause impairment include negative industry or economic trends or significant underperformance relative to historical or projected future operating results.

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

Other Assets

Capitalized loan fees are recorded at cost less accumulated amortization. The costs are determined at the time the loan transactions are closed and are amortized over the life of the loan using a method which approximates the effective interest method.

Income Taxes

The Company and its includable subsidiaries file a consolidated U.S. federal income tax return in accordance with the provisions of the Internal Revenue Code of 1986, as amended.

The Company's accounting for income taxes represents management's best estimate of various events and transactions.

Deferred tax assets and liabilities resulting from temporary differences between the financial reporting and tax bases of assets and liabilities are measured at the balance sheet date using enacted tax rates expected to apply to taxable income in the years the temporary differences are expected to reverse.

The realization of deferred tax assets depends upon the existence of sufficient taxable income within the carryback or carryforward periods under the tax law in the applicable tax jurisdiction. Valuation allowances are established when management determines, based on available information, that it is more likely than not that deferred income tax assets will not be realized. Significant judgment is required in determining whether valuation allowances should be established as well as the amount of such allowances. When making such determination, consideration is given to, among other things, the following:

- future taxable income exclusive of reversing temporary differences and carryforwards;
- future reversals of existing taxable temporary differences;
- taxable income in prior carryback years and
- tax planning strategies.

The Company believes that it will ultimately recover a majority of the deferred tax assets recorded on its consolidated balance sheets. However, should there be a change in the Company's ability to recover its deferred tax assets, its tax provision would increase in the period in which it was determined that the recovery was not likely.

The Company re-evaluates uncertain tax positions on a regular basis. This evaluation is based on factors such as changes in facts or circumstances, changes in tax law, new audit activity, and effectively settled issues. Determining whether an uncertain tax position is effectively settled requires judgment. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision.

The Company classifies tax related interest and tax related penalties as a component of income taxes.

Revenue Recognition

The Company generally recognizes revenue from sales of its products when the following have occurred: evidence of a sale arrangement exists; delivery or shipment has occurred or services have been rendered; the price to the buyer is fixed or determinable; and collectability is reasonably assured.

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

For fixed-price contracts, the Company may recognize revenue on a Multiple-Element Arrangement basis. The Multiple-Element Arrangement method requires the Company to evaluate all deliverables in an arrangement to determine whether they represent separate units of accounting. The Company makes that determination at the inception of the arrangement. In an arrangement with multiple deliverables, the delivered item(s) shall be considered a separate unit of accounting if (a) the delivered item(s) have value to the customer on a standalone basis, (b) there is objective and reliable evidence of the fair value of the undelivered item(s), and (c) if the arrangement includes a general right of return relative to the delivered item(s) and delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the buyer. The Company may also recognize its revenue under the completed contract method.

For long-term, fixed-price contracts meeting certain criteria, the Company may elect to follow the percentage-of-completion method of accounting for revenue recognition. Under this method, contract revenue is computed as that percentage of estimated total revenue that costs incurred to date bear to total estimated costs, after giving effect to the most recent estimates of costs to complete. From time to time, the Company will record costs and estimated profits in excess of billings for a contract. Revisions in costs and revenue estimates are reflected in the period in which the revisions are determined. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined without regard to the percentage-of-completion.

Periodically the Company enters into research and development contracts with customers related primarily to aircraft instruments and sensors. When the contracts provide for milestone or other interim payments, the Company will recognize revenue either under the Milestone method or the Multiple-Element Arrangement method. Contracts in process during fiscal year 2013, presented as contracts B, D and E, are being accounted for under the Milestone method. The Milestone method requires the Company to deem all milestone payments within each contract as either substantive or non-substantive. That conclusion is determined based upon a thorough review of each contract and the Company's deliverables committed to in each contract. For substantive milestones, the Company concludes that upon achievement of each milestone, the amount of the corresponding defined payment is commensurate with the effort required to achieve such milestone or the value of the delivered item. The payment associated with each milestone relates solely to past performance and is deemed reasonable upon consideration of the deliverables and the payment terms within the contract. For non-substantive milestones, including advance payments, the recognition of such payments are pro-rated to the substantive milestones. Milestones may include, for example, the successful completion of design review or technical review, the submission and acceptance of technical drawings, delivery of hardware, software, spares, test equipment or regulatory agency certifications. During fiscal year 2013, revenue recognized through the achievement of multiple milestones related to contracts B, D and E amounted to $1,513,000.

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AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

Milestone considerations for contracts in process during fiscal year 2013 include:

Contract B (Completed in fiscal year 2013)	Milestone consideration
Milestone 1 (Substantive)	$ 100,000
Milestone 2 (Substantive)	29,000
Milestone 3 (Substantive)	100,000
Milestone 4 (Substantive)	41,000
Milestone 5 (Substantive)	10,000
Milestone 6 (Substantive)	115,000
Milestone 7 (Substantive)	38,000
Milestone 8 (Substantive)	73,000
Milestone 9 (Substantive)	51,000
Milestone 10 (Substantive)	82,000
Milestone 11 (Substantive)	23,000
	$ 662,000

Contract D	Milestone consideration
Milestone 1 (Substantive)	$ 319,000
Milestone 2 (Substantive)	333,000
Milestone 3 (Substantive)	196,000
Milestone 4 (Substantive)	40,000
	$ 888,000

Contract E	Milestone consideration
Milestone 1 (Non Substantive)	$ 187,500
Milestone 2 (Substantive)	187,500
Milestone 3 (Substantive)	318,750
Milestone 4 (Substantive)	56,250
	$ 750,000

When there is no milestone or other interim payments, revenue is generally recognized at completion.

As a general matter, the terms specified in customer purchase orders determine whether the Company or the customer bears the obligation for payment of freight charges. While customers pay for freight in most transactions, the Company does occasionally pay freight charges on behalf of customers and may bill all or a portion to customers.

Research and Development

R&D costs that are not associated with specific customer contract requirements are expensed and included in selling, general and administrative expenses and approximated $3,684,000 and $1,312,000 for the years ended January 31, 2013 and 2012, respectively. Unrecognized R&D costs that are associated with specific customer contract requirements are presented as a deferred charge in prepaid expenses and other current assets, net and approximated $267,000 and $1,332,000 as of January 31, 2013 and January 31, 2012, respectively. Recognized R&D costs that are associated with specific customer contract requirements are expensed and included in selling, general and administrative expenses approximated $1,264,000 and $1,407,000 for the years ended January 31, 2013 and January 31, 2012, respectively.

Environmental Expenditures

The Company assesses its property held for sale, along with any property that is being taken out of its initially intended use, for the presence of hazardous or toxic substances that would result in an environmental liability. In addition, management assesses its current property in use for any environmental issues.

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

Liabilities for environmental remediation costs not related to retirements of tangible long-lived assets, and arising from claims, assessments, litigation, fines, and penalties and other sources, are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated.

Legal costs incurred in connection with environmental remediation are expensed as incurred. Recoveries of environmental remediation costs from third parties, which are probable of realization, are separately recorded as assets, and are not offset against the related environmental liability, in accordance with U.S. GAAP.

Treasury Stock

The Company accounts for the acquisition of treasury shares at cost. The Company has not reissued acquired shares.

Stock-Based Compensation

U.S. GAAP requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. Under this method, in addition to reflecting compensation for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro-forma disclosure in prior periods. U.S. GAAP requires that the cost of all share-based transactions be measured at fair value and recognized over the period during which a grantee is required to provide goods or services in exchange for the award. Although the terms of the Company's share-based plans do not accelerate vesting upon retirement, or the attainment of retirement eligibility, the requisite service period subsequent to attaining such eligibility is considered non-substantive. Accordingly, the Company recognizes compensation expense related to share-based awards over the shorter of the requisite service period or the period to attainment of retirement eligibility. U.S. GAAP also requires an estimation of future forfeitures of share-based awards to be incorporated into the determination of compensation expense when recognizing expense over the requisite service period.

Although the Company did not issue stock options to employees during fiscal year 2013, the Company issued 22,000 stock options to employees during fiscal year 2012. The weighted average per share fair value of options granted was determined using the Black-Scholes option-pricing model with the following assumptions (See Note 10 for further discussion of stock-based compensation):

	2012	
Volatility	67	%
Risk-free interest rate	0.25	%
Expected life in years	10.00	
Dividend yield	0	%

Income per Share

Basic income per share is computed using the weighted average number of shares of common stock outstanding. Diluted income per share is computed by dividing net income available to common stockholders by the weighted average number of shares of common stock outstanding for the period, adjusted for the dilutive effect of potential common stock, using the treasury stock method.

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

Concentrations of Credit Risk

Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable. As of January 31, 2013 and 2012, substantially all of the Company's cash balances were deposited with financial institutions determined by management to be of high credit quality. During the normal course of business, the Company extends credit, without collateral, to customers conducting business in the aerospace industry worldwide.

Exchange Rate Fluctuation

The Company conducts a limited amount of business in transactions that are denominated in foreign currencies. The Company employs a method of matching accounts receivable denominated in foreign currencies with accounts payable denominated in foreign currencies to mitigate this risk. These amounts have been insignificant.

Financial Instruments

U.S. GAAP requires disclosure of the fair value of certain financial instruments. Cash, accounts receivable, short-term borrowings and certain accrued liabilities are included in the consolidated financial statements at amounts which approximate fair value because of the short term nature of these instruments. The carrying amount of long-term debt at January 31, 2013 and 2012 approximates fair value as these instruments have adjustable rates which change in accordance with the market.

Adoption of New Accounting Pronouncements

In September 2011, the FASB amended the guidance on the annual testing of goodwill for impairment. The amended guidance allows companies to assess qualitative factors to determine if it is more likely than not that goodwill might be impaired and whether it is necessary to perform the two-step goodwill impairment test required under current accounting standards. This guidance is effective for the Company's fiscal year ending January 31, 2013. The Company

has determined that this new guidance does not have a material impact on its consolidated financial statements.

In July 2012, the FASB amended guidance on the annual testing of indefinite-lived intangible assets for impairment. Under the amended guidance, an entity has the option first to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount. This guidance will be effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. The Company has determined that this new guidance will not have a material impact on its consolidated financial statements.

In February 2013, the FASB issued guidance on the Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income. The guidance requires that companies present either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source (e.g., the release due to cash flow hedges from interest rate contracts) and the income statement line items affected by the reclassification (e.g., interest income or interest expense). If a component is not required to be reclassified to net income in its entirety (e.g., the net periodic pension cost), companies would instead cross reference to the related footnote for additional information (e.g., the pension footnote). This guidance is effective for fiscal and interim reporting periods beginning after December 15, 2012. The adoption of this guidance is not expected to have a material effect on the Company’s consolidated financial statements.

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

2. Accounts Receivable

Accounts receivable at January 31, 2013 and 2012 consisted of the following:

	2013	2012
Accounts receivable, trade	$5,811,000	$5,548,000
Less: allowance for doubtful accounts	(403,000)	(358,000)
Accounts receivable, net	$5,408,000	$5,190,000

The Company's allowance for doubtful accounts activity for the years ended January 31, 2013 and 2012 was as follows:

	2013	2012
Beginning balance	$358,000	$608,000
Amounts written off	(151,000)	(368,000)
Amounts provided for	196,000	118,000
Ending balance	$403,000	$358,000

3. Prepaid Expenses and Other Current Assets

Included in, and making up the majority of, prepaid expenses and other current assets was $267,000 and $1,332,000 of deferred charges related to several current engineering contracts as of January 31, 2013 and January 31, 2012, respectively. The Company has been retained for the development of customer specific engineering projects. All the contracts are short-term in nature and not expected to extend beyond twelve months. As of January 31, 2013, the deferred charges consist of $166,000 of internal engineering labor, including overhead, and $101,000 of external engineering contract labor. As of January 31, 2012, the deferred charges consist of $1,332,000 of internal engineering labor, including overhead, and $0 of external engineering contract labor. The deferred charges are offset by residual interim payments from customers of $19,000 and $0 as of January 31, 2013 and January 31, 2012, respectively. Related to the deferred charges are accrued contract losses of $71,000 and $1,086,000 as of January 31, 2013 and January 31, 2012, respectively, which are included in accrued expenses and other liabilities.

Prepaid expenses and other current assets, net consisted of the following:

	2013	2012
Deferred charges on engineering contracts, net	$267,000	$1,332,000
Prepaid insurance expenses	223,000	266,000
Other prepaid expenses	92,000	204,000
Prepaid expenses and other current assets, net	$582,000	$1,802,000

4. Inventories

Inventories at January 31, 2013 and 2012 consisted of the following:

AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

	2013	2012
Raw materials	$7,627,000	$6,626,000
Work in process	2,619,000	2,005,000
Finished goods	21,000	381,000
Reserve for obsolete and slow moving inventory	(2,072,000)	(2,219,000)
Inventories, net	$8,195,000	$6,793,000

The Company's reserve for obsolete and slow moving inventory activity for the years ended January 31, 2013 and 2012 was as follows:

	2013	2012
Beginning balance	$2,219,000	$2,424,000
Amounts written off	(289,000)	(315,000)
Amounts charged to operations	142,000	110,000
Ending balance	$2,072,000	$2,219,000

5. Property, Plant and Equipment

Property, plant and equipment at January 31, 2013 and 2012 consisted of the following:

	2013	2012
Land and improvements	$173,000	$173,000
Building and improvements	2,522,000	2,510,000
Machinery and equipment	7,207,000	6,724,000
Patterns, dies and tools	691,000	611,000
Furniture and fixtures	1,801,000	1,635,000
Construction in progress	695,000	776,000
	13,089,000	12,429,000
Less: accumulated depreciation	(8,555,000)	(8,223,000)
Property, plant and equipment, net	$4,534,000	$4,206,000

Depreciation expense was $451,000 and $380,000 for the years ended January 31, 2013 and 2012, respectively. Certain components of property, plant and equipment are pledged as collateral for debt obligations. See Note 9 for further discussion of collateralized property, plant and equipment.

6. Intangible Assets

Intangible assets as of January 31, 2013 and 2012 consisted of the following:

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AEROSONIC CORPORATION AND SUBSIDIARIES

Notes to the Consolidated Financial Statements

	Useful Lives	2013	2012
Intangible assets subject to amortization:			
Acquired product prototype	5	$-	$730,000
Non-compete agreeements	3	-	175,000
Acquired customer base	5	-	75,000
Total intangible assets subject to amortization		-	980,000
Accumulated amortization		-	(886,000)
Net		$-	$94,000
Intangible assets with indefinite lives:			
Goodwill		$366,000	$366,000

Amortization expense related to intangible assets for the years ended January 31, 2013 and 2012 was $94,000 and $161,000, respectively. During the year ending January 31, 2013, the intangible assets were fully amortized.

Amortization expense related to capitalized debt issuance costs for the years ended January 31, 2013 and 2012 was $37,000 and $36,000, respectively. As more fully described in Note 9, on January 31, 2013, the Company renewed its Long-term Debt and Revolving Credit Facility prior to its maturity dates. As a result of the early renewal, the Company recognized accelerated amortization expense in the amount of $9,000 for the year ended January 31, 2013, which is reported as loss on extinguishment of debt, presented separately on the Consolidated Statement of Operations.

Amortization expense related to intangible assets and capitalized debt issuance costs is included in selling, general and administrative expenses. Capitalized debt issuance costs are included in other assets.

On January 21, 2013, the Company entered into a Development Collaboration and Intellectual Property Agreement with LG CNS Co., Ltd. (“LG”). The Collaboration Agreement provides for the sale of certain intellectual property of the Company (the “Purchased IP”) to LG. The aggregate purchase price for the Purchased IP is $2,300,000, $1,553,000 of which was already paid to the Company. The remainder of the purchase price is payable by LG to the Company in two lump sum payments in January 2016 and January 2017. The Company reported a gain on sale of $1,990,000, presented in Other Income.

7. Notes Payable

On May 14, 2009, the Company entered into three separate unsecured notes payable, herein referred to collectively as the “Notes Payable”, with three separate private lenders, Bruce J. Stone, Redmond Family Investments, LLLP and Martin L. Schaffel, herein referred to collectively as “the Investors”, each containing a drawdown provision allowing the Company to borrow up to an aggregate of $2,000,000. The loan agreements, entered into in connection with the Notes Payable (the “Loan Agreements”), initially provided for the issuance of warrants with an exercise price of $0.64 per warrant issued at the rate of one warrant for every four dollars loaned to the Company and common shares at the rate of one share for every ten dollars loaned to the Company. Additionally, any amounts borrowed are subject to 14% interest per annum, payable monthly.

On May 21, 2009, the Company borrowed an aggregate principal amount of $800,000 based upon the cash drawdown provision of each of the three unsecured loan agreements. The 200,000 warrants issued to the Investors pursuant to the $800,000 drawdown are exercisable at any time during the period after May 21, 2010 and before the warrant expiration date of April 10, 2015. The Company also issued 80,000 common shares in connection with the $800,000 cash. The aggregate amount borrowed of $800,000 was initially payable in full under each of the three Notes Payable on or before April 10, 2010.

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On February 19, 2010, the Company borrowed an additional $600,000 from the Investors under the Loan Agreements entered into on May 14, 2009 and also entered into amendments to each of the Loan Agreements with the Investors. The note modifications (a) extended the maturity date of the subordinated notes for a period of one year from April 10, 2010 to April 10, 2011, (b) removed Aerosonic's obligation to issue shares of its common stock upon each cash drawdown made on or after February 19, 2010, (c) revised the ratio of common shares underlying warrants issuable per each $1.00 of principal amount borrowed from ".25 shares per $1.00 of principal amount" to ".20 shares per $1.00 of principal amount" with respect to cash draw downs made on or after February 19, 2010 and (d) deleted certain negative covenants relating to the issuance of securities. The warrant modifications (a) extended the expiration date of any warrants issued prior to February 19, 2010 for a period of five years from April 10, 2015 to April 10, 2020, (b) extended the expiration date of any warrants issued on or after February 19, 2010 from April 10, 2015 to the sixth anniversary date of the issuance of the warrant certificate and (c) revised the purchase price for any warrants issued on or after February 19, 2010 from $0.64 per share to a price equal to 50% of the volume weighted average of the selling price of the Company's common stock on February 12, 2010 and for the 19 trading days prior to February 12, 2010, or $1.98 per share. The 120,000 warrants issued to the Investors pursuant to the additional $600,000 loan are exercisable at any time before the expiration date of February 19, 2016.

On October 13, 2010, the Company repaid $700,000 of the outstanding balance of the Notes Payable, with each Investor receiving a pro-rata portion of the aggregate repayment amount based on the Investors' balance on that date.

On December 31, 2010, the Company repaid an additional $100,000 of the outstanding balances of the Notes Payable, with each Investor receiving a pro-rata portion of the aggregate repayment amount based on the Investors' balance on that date.

During the first quarter of fiscal year 2012, the Company repaid the remaining outstanding balance of the Notes Payable, with each Investor receiving a pro-rata portion of the aggregate repayment amount based on the Investors' balance on that date.

The warrants and common shares issued under the Loan Agreements described above are recorded as a separate component of interest and are being accreted into the loan balances over the term of the loans. For the year ended January 31 2012, the Company recognized accretion of $26,000 presented as additional interest expense. In addition, as a result of early repayments to the Investors, the Company recognized accelerated interest accretion expense in the amount of $25,000 for the year ended January 31, 2012 which is reported as loss on extinguishment of debt.

8. Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities at January 31, 2013 and 2012 consisted of the following:

	2013	2012
Environmental liability (see Note 13)	$404,000	$788,000
Contract costs provision	278,000	-
Contract loss provision	71,000	1,086,000
Warranty liability	167,000	226,000
Other	411,000	398,000
Accrued expenses and other liabilities	$1,331,000	$2,498,000

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Contract Costs Provision

As of January 31, 2013, the Company accrued costs of $278,000 associated with two customer funded fixed price development contracts accounted for using the milestone method. As of January 31, 2013, neither contract required a provision for contract loss.

Contract Loss Provision

As of January 31, 2013, the Company recognized a contract loss provision of $71,000 associated with one customer funded fixed price development contract. As of January 31, 2012, the Company recognized a contract loss provision of $1,086,000 associated with one customer funded fixed price development contract. As of January 31, 2013, remaining revenues associated to one uncompleted project amounted to $40,000. As of January 31, 2012, remaining revenues associated to one uncompleted project amounted to $308,000.

Warranty Liability

The Company has established a liability for warranty claims based on historical experience, which has not been significant. The Company's warranty activity for the years ended January 31, 2013 and 2012 was as follows:

	2013	2012
Beginning balance	$226,000	$144,000
Cost incurred	(146,000)	(162,000)
Provision for warranty cost	87,000	244,000
Ending balance	$167,000	$226,000

9. Long-term Debt and Revolving Credit Facility

The Company is party to a Loan Agreement (the “Loan Agreement”), dated April 30, 2010, with BMO Harris Bank, the “Lender”, for a Credit Facility with a maximum amount available to the Company of $10,100,000. The Loan Agreement provides for (a) a $4,000,000 revolving line of credit (the “Revolving Credit Line Note”), (b) a $3,500,000 first real estate mortgage loan (the “Real Estate Mortgage Note”), (c) a $1,900,000 term loan (the “Equipment Term Note” and together with the Real Estate Mortgage Note, the “Bank Notes”), and (d) a $700,000 equipment line of credit (the “Equipment Credit Line Note” and together with the Revolving Credit Line Note, the “Credit Line Notes”). The available funds received and financing available under the Loan Agreement will be and have been used for new product development, working capital and capital expenditure needs. Pursuant to a First Amendment to Amended and Restated Revolving Credit Line Note, dated June 15, 2012, the Company and the Lender agreed to extend the maturity date of the Amended and Restated Revolving Credit Line Note to June 27, 2013.

The Credit Facility is secured by substantially all assets of the Company. Details of the Credit Facility are as follows:

- The Amended and Restated Revolving Credit Line Note provides a line of credit in an amount equal to the lesser of (a) the Revolving Credit Limit of $4,000,000; or (b) a Borrowing Base determined based on eligible accounts receivable and inventory. Interest is paid monthly. The interest rate on the Amended and Restated Revolving Credit Line Note is one-month LIBOR (which was 0.2087% at January 31, 2013) plus 300 basis points. Available borrowings on the Amended and Restated Revolving Credit Line Note at January 31, 2013 were $3,097,000.
- The Real Estate Mortgage Note, which supports a $3,500,000 first real estate mortgage loan, has a three-year term, a 15-year amortization period, and the interest rate is one-month LIBOR plus 340 basis points with a 4% floor. Interest and principal are paid monthly. The proceeds of the Real Estate Mortgage Note were used for refinancing an existing loan relating to the Clearwater, Florida property and for working capital and capital expenditure needs.

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- The Equipment Term Note, which supports a $1,900,000 term loan, has a three-year term, a five-year amortization period, and the interest rate is one-month LIBOR plus 340 basis points with a 4% floor. Interest and principal are paid monthly. The proceeds of the Equipment Term Note were used for refinancing an existing loan relating to the Earlysville, Virginia property and for working capital and capital expenditure needs. The Company must pay any proceeds from the sale of the Earlysville, Virginia property to BMO Harris Bank to be applied as a principal payment under the Equipment Term Note.
- The Equipment Credit Line Note, which supports a $700,000 equipment line of credit, has a three-year term, a five-year amortization period, and the interest rate is one-month LIBOR plus 325 basis points with a 4% floor. Interest is paid monthly. Principal payments began October 2011. Proceeds are used to purchase equipment for use in the Company's business. The Equipment Credit Line Note matures on May 1, 2014.

Prior to the Third Amendment, noted below, the Credit Facility contained certain financial and other restrictive covenants, including the requirement to maintain: (i) on a consolidated basis, Total Stockholders' Equity, defined as the value of total assets less total liabilities, equal to at least $7,419,000, which amount shall increase on a quarterly basis in an amount equal to ninety percent (90%) of the Company's net income (calculated on a consolidated basis) for such quarter; (ii) on a consolidated basis, a ratio of Funded Debt, defined as all outstanding liabilities for borrowed money and other interest-bearing liabilities, including current and long term debt, less the non-current portion of Subordinated Liabilities, defined as liabilities subordinated to the Company's obligations to the lender in a manner acceptable to the lender in its sole discretion, to EBITDA not exceeding 3.0:1.0; and (iii) on a consolidated basis, a Fixed Charge Coverage Ratio, defined as the ratio of (a) the sum of EBITDA plus lease expense and rent expense, minus income tax, minus dividends, withdrawals, and other distributions, to (b) the sum of cash interest expense, lease expense, rent expense, scheduled principal amortization actually paid to the lender during the measuring period (excluding any principal payments under the Amended and Restated Revolving Credit Line Note and the Investors' Notes Payable), and scheduled payments on capitalized lease obligations during the measuring period, of at least 1.20:1.0. These covenant amounts were calculated at the end of each quarterly reporting period for which the lender required financial statements.

On January 31, 2013, the Company entered into an amendment (the "Third Amendment") to the Loan Agreement. The Amendment (a) renews to January 31, 2016, the maturity date of the Amended and Restated Revolving Credit Line Note in the amount of $4 million; (b) renews to May 1, 2015, the maturity date of the Equipment Term Note in the amount of $887,000, and (c) renews to January 31, 2018, the maturity date of the Real Estate Mortgage Note in the approximate amount of $2,877,000. Except as amended to extend their respective maturities, the new notes contain the same terms and conditions as the promissory notes that they replace. The Third Amendment adjusts the Company's requirement to retain Total Stockholders' Equity to no less than $8,759,000.

For the periods measured as of January 31, 2012, April 27, 2012, July 27, 2012, October 26, 2012 and January 31, 2013, the Company was in compliance with all covenants within the Credit Facility.

Long-term debt at January 31, 2013 and January 31, 2012 consisted of the following:

	2013	2012
Real Estate Mortgage Note	2,877,000	3,111,000
Equipment Term Note	887,000	1,267,000
Equipment Credit Line Note	510,000	653,000
	4,274,000	5,031,000
Less: current maturities	(763,000)	(753,000)
Long-term debt, less current maturities	$3,511,000	$4,278,000

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At January 31, 2013, principal repayment of Long-term debt consisted of the following:

	2014	2015	2016	2017	2018
Revolving Credit Facility	-	-	903,000	-	-
Real Estate Mortgage Note	233,000	233,000	233,000	233,000	1,945,000
Equipment Term Note	380,000	380,000	127,000	-	-
Equipment Credit Line Note	150,000	360,000	-	-	-
	763,000	973,000	1,263,000	233,000	1,945,000

Interest and accretion expense on long-term debt and the Amended and Restated Revolving Credit Line Note for the fiscal year ended January 31, 2013 and January 31, 2012 amounted to $258,000 and $371,000, respectively.

10. Stockholders' Equity

Income Per Share

Basic income per share is based upon the Company's weighted average number of common shares outstanding during each period. Diluted income per share is based upon the weighted average number of common shares outstanding during each period, assuming the issuance of common shares for all dilutive potential common shares outstanding during the period, using the treasury stock method. Potential common stock of 118,000 and 122,000 shares were not included in the computation of diluted income per share for the years ended January 31, 2013 and 2012, respectively, as the inclusion of the potential common stock would be anti-dilutive.

	Years Ended January 31,	
	2013	2012
Weighted average shares outstanding-basic	3,782,861	3,760,483
Dilutive effect of stock options and warrants	310,664	286,533
Weighted average shares outstanding-diluted	4,093,525	4,047,016

Options to Purchase Stock

In July 2004, the Company adopted the Aerosonic Corporation 2004 Stock Incentive Plan ("2004 SIP"), which authorized the awarding of options to purchase up to a total of 400,000 shares of the Company's common stock. For option awards, the 2004 SIP provides that the strike price shall not be less than the fair market value of the common stock on the date of grant and that no portion of any option award may be exercised beyond ten years from that date. In addition, no incentive stock option can be granted and exercised beyond five years to a stockholder owning 10% or more of the Company's outstanding common stock. On July 13, 2009, stockholders approved an amendment to the Aerosonic Corporation 2004 Stock Incentive Plan (the Plan) that extended the duration of the Plan for five years to July 14, 2014 and increased the total number of shares of Aerosonic common stock issuable pursuant to the Plan from 400,000 shares of common stock to 550,000 shares.

During the first quarter of fiscal year 2012, the Company issued to its President and Chief Executive Officer, options to purchase 6,000 shares of the Company's common stock at the common stock's market price on that day of $2.70. Additionally, the Company issued to its Executive Vice President and Chief Financial Officer, its Executive Vice President of Sales and Marketing and its Executive Vice President and Chief Operating Officer, options to purchase 4,000 shares each of the Company's common stock at the common stock's market price on that day of $2.87. In the second quarter of fiscal year 2012, the Company issued to its Vice President of Technology and Product Development, options to purchase 4,000 shares of the Company's common stock at the common stock's market price on that day of $3.06, These options vest from one to three years from the date of grant.

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On April 20, 2012, stockholders approved an amendment to the Plan that increased the total number of shares of Aerosonic common stock issuable pursuant to the Plan from 550,000 shares of common stock to 750,000 shares.

During the fiscal year ended January 31, 2013, no stock options were issued.

A summary of the activity related to the Company's stock options during fiscal year 2013 and 2012 is presented in the table below:

	Years Ended January 31, 2013			2012		
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In years)	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (In years)
Beginning options outstanding	339,200	$ 2.83		320,200	$ 2.82	
Options granted	-	$ -		22,000	$ 2.86	
Options exercised	(3,300)	$ 1.32		(1,000)	$ 1.01	
Options expired, cancelled or forfeited	(5,800)	$ 1.88		(2,000)	$ 1.87	
Ending options outstanding	330,100	$ 2.87	5.79	339,200	$ 2.83	6.81
Options exercisable at January 31,	315,400	$ 2.87	5.68	250,000	$ 3.09	6.54

Stock options vest over a period of two to four years and have 10-year terms. Exercise prices of stock options awarded for all periods were equal to the market price of the stock on the date of grant. The weighted average grant date fair value per share of options granted during the years ended January 31, 2013 and 2012, vested and unvested, was $0 and $2.83, respectively.

As of January 31, 2013, there was approximately $18,000 of unrecognized compensation cost related to unvested options. This cost is expected to be recognized over a weighted average period of approximately 1.2 years.

The Company recorded equity-based compensation expense on its options in accordance with U.S. GAAP of approximately $39,000 and $127,000 for the years ended January 31, 2013 and 2012, respectively, which is included in selling, general and administrative expenses.

During the fiscal years ended January 31, 2013 and January 31, 2012, option holders exercised 3,334 and 1,000 options, respectively.

11. Income Taxes

Income tax (benefit) expense for the years ended January 31, 2013 and 2012 consisted of:

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	2013	2012
Current:		
Federal	$-	$-
State	-	-
	-	-
Deferred:		
Federal	839,000	397,000
State	81,000	39,000
	920,000	436,000
Income tax expense	$920,000	$436,000

The following table illustrates the difference between the statutory income tax rates applicable to the Company versus the effective tax expense rate for the years ended January 31, 2013 and 2012:

	2013	2012
Federal tax rate	34.0 %	34.0%
Increase (decrease) in taxes resulting from:		
State income taxes, net of federal tax benefit	3.4	4.1
Intrinsic costs warrants	-	2.1
Stock based compensation	0.4	5.2
Research and development tax credit	(11.4)	5.9
Other - primarily non-deductible expenses	0.2	1.4
Effective tax rate	26.6 %	52.7%

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at January 31, 2013 and 2012 were as follows:

	2013	2012
Current deferred tax assets:		
Accounts receivable	$150,000	$133,000
Inventories	1,117,000	1,130,000
Compensation expense	169,000	187,000
Contract loss	(25,000)	15,000
Other	64,000	84,000
Total current deferred tax assets	1,475,000	1,549,000
Non-current deferred tax assets:		

Property, plant and equipment, principally due to differences in depreciation and capitalized interest	(843,000)	(133,000)
Building held for sale	62,000	70,000
Research and experimentation and alternative minimum tax credits	888,000	325,000
Stock-based compensation	-	-
Net operating loss carryforward	185,000	508,000
Total non-current deferred tax assets	292,000	770,000
Total deferred tax asset	1,767,000	2,319,000
Non-current deferred tax liabilities:		
Identifiable intangibles	224,000	35,000
Net deferred tax asset	$1,543,000	$2,284,000

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At January 31, 2013, the Company has a total net operating loss carryforward for U.S. Federal tax purposes of approximately $496,000 and research and development tax credits of $623,000 which expire in various years through 2029.

Realization of the Company's net deferred tax asset is dependent upon the Company generating sufficient taxable income in future years to obtain a benefit from the reversal of deductible temporary differences and from tax loss carryforwards. The Company has concluded that, based on expected future results and the future reversals of existing taxable temporary differences, a reserve is not needed at January 31, 2013.

The Company records provisions dealing with uncertain tax positions as required in ASC740. As a result, the Company has recorded a liability of $0 at January 31, 2013 and 2012, of unrecognized tax benefits, inclusive of estimated accrued interest and penalties. At January 31, 2013, there was no accrued interest or accrued penalties related to uncertain tax positions.

The Company is generally no longer subject to examinations with respect to returns that have been filed for years prior to 2010.

The Company is not currently under examination by any taxing authority. We do not anticipate that the amount of the unrecognized benefit will significantly increase or decrease within the next twelve months.

12. Major Customer Information

Direct and indirect sales to U.S. Government agencies, when combined, amounted to approximately $10,275,000, representing 33%, and $13,112,000, representing 44%, for the years ended January 31, 2013 and 2012, respectively. Of these amounts, approximately $5,901,000 and $6,365,000 were sales directly to U.S. Government agencies for the years ended January 31, 2013 and 2012, respectively. The remaining amounts of $4,374,000 and $6,747,000 represent sales to commercial customers for government applications for the years ended January 31, 2013 and 2012, respectively.

Foreign sales for the years ended January 31, 2013 and 2012 were approximately $8,085,000 and $5,903,000, respectively. Substantially all foreign sales contracts are payable in U.S. dollars.

Sales to the U.S. Government, Korea Aerospace Industries, Carp Industries and The Boeing Company represented approximately 19%, 11%, 10% and 10% of total sales for the year ended January 31, 2013, respectively. Accounts receivable at January 31, 2013 included approximately $1,082,000 due from Korea Aerospace Industries and $704,000 due from Carp Industries. Accounts receivable at January 31, 2012 included approximately $1,118,000 due from Alenia Aermacchi, $882,000 due from the U.S. Government and $654,000 due from Carp Industries. No other customer represented greater than 10% of accounts receivable at January 31, 2013 or 2012.

13. Commitments and Contingencies

Commitments

Purchase commitments

At January 31, 2013, the Company was committed to future purchases of approximately $6,092,000 for materials and services as well as a development contract. These purchase commitments are supported by firm underlying contracts with customers and contain provisions permitting the Company to terminate such purchase commitments in the event the underlying contracts should be terminated or discontinued.

Purchase commitments as of January 31, 2013 are as follows:

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	Payments Due By Period				
	Less Than One Year	One Year to 3 Years	Greater Than 3 Years to 5 Years	After 5 Years	Total
Purchase commitments	$5,681,000	$ 411,000	$ -	$ -	$6,092,000

Leases

On September 20, 2007, the Company entered into a five year operating lease at a location near Charlottesville, Virginia, which represents the new facility for the support and repair/overhaul employees of Avionics who were retained subsequent to the consolidation of the Earlysville operations into the Clearwater facility. Total rental expense was approximately $152,000 and $167,000 for the years ended January 31, 2013 and 2012, respectively, which is included in cost of sales. During fiscal year 2013, the lease term expired.

At January 31, 2013, there are no future minimum rental payments under leases that have initial or remaining non-cancelable lease terms in excess of one year.

Contingencies

Litigation

From time to time, the Company may be involved in certain claims and legal actions arising in the ordinary course of business. As of January 31, 2013, there were no claims or legal actions that will have a material adverse effect on the Company's financial position, results of operations, or liquidity.

Environmental

In preparation for the sale of the Earlysville, Virginia facility, the Company engaged an environmental consulting firm to survey the property for any possible soil or groundwater contamination. This survey revealed impacts to both shallow soils and groundwater that may have resulted from the accidental loss of solvents by a former owner of the property. During fiscal year 2013, the Company signed an administrative order on consent with the U.S. Environmental Protection Agency to provide the former owner with access to the property and the former owner of the property signed an administrative order on consent with the U.S. Environmental Protection Agency for completion of a contamination characterization study. As a result of the initial and subsequent surveys, the Company's responsibility for the remaining contamination treatment, future monitoring, oversight and other related costs is estimated at $404,000 as of January 31, 2013. The Company has capitalized these costs as an increase to property held for sale, net, since such costs will be incurred in preparation for the sale of the Earlysville, Virginia facility and will not result in a carrying value in excess of the estimated fair value less cost to sell. Costs incurred during fiscal year 2013 totaled $22,000 and costs incurred during the fiscal year ended January 31, 2012 totaled $20,000. At this time, the Company cannot predict how much, if any, it will incur for more costs in fiscal year 2014.

U.S. Government Defense Budget/Sequestration

In August 2011, the Budget Control Act reduced the U.S. DoD top line budget by approximately $490 billion through 2021. In addition, U.S. government expenditures are subject to the potential for further reductions, generally referred to as "sequestration". Sequestration would result in additional reductions of approximately $500 billion from the defense top line budget through 2021. The Office of Management and Budget (OMB) has estimated that sequestration would reduce non-exempt defense discretionary accounts during U.S. government fiscal year 2013 by approximately 9.4% (excluding military personnel accounts). The OMB has further stated that the budget for Overseas Contingency Operations and any unobligated balances in prior year funds would be included in aggregate reductions, but has otherwise indicated that it cannot yet assess the impact of sequestration at the program, project, and activity level. The U.S. DoD has indicated that such reductions might require the termination of certain, as yet undetermined, procurement programs and other U.S. government customers, such as NASA and various intelligence agencies, may be required to take comparable actions. Any such impacts could have a material effect on our results of operations, financial position and/or cash flows.

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Repayment Guaranty and performance Guaranty

On August 2, 2012, the Company entered into a stand-by letter of credit agreement with BMO Harris Bank in the amount of $187,500 related to our commitment for the repayment of a cash advance from a certain customer upon our failure to timely perform. This agreement had no effect on reducing the amount of credit available on the Amended and Restated Revolving Credit Line Note as of January 31, 2013. As of January 31, 2013, as a result of the Company's timely performance, the stand-by letter of credit is void. In addition, the Company guaranteed 10% of the contract price, or $75,000, should the Company fail to deliver hardware. The contract subjects the Company to liquidated damages, limited to 10% of the total amount paid to the seller to date, for failure to timely deliver hardware. As of January 31, 2013, the Company expects to timely perform on the contract and avoid all contract damages.

14. Employee Retirement Plan

The Company's employees are eligible, after completing three months of service, to participate in a 401(k) plan (the "Plan") sponsored by Aerosonic Corporation. Under the terms of the Plan, employees may contribute up to 15% of their gross earnings subject to IRS limitations. The Company may match up to 100% of the first 3% of employees' contributions. The Company's matching contributions to the Plan were $273,000 and $222,000 for the years ended January 31, 2013 and 2012, respectively and are included in selling, general and administrative expenses.

15. Quarterly Data (Unaudited)

Set forth below are the Company's quarterly data (unaudited) for the years ended January 31, 2013 and 2012.

	Quarters Ended			
	April 27	July 27	October 26	January 31
2013				
Sales, net	$7,361,000	$7,472,000	$7,267,000	$8,921,000
Gross profit	$2,858,000	$2,247,000	$3,135,000	$3,690,000
Operating income (loss)	$720,000	$(161,000)	$765,000	$467,000
Net income (loss)	$413,000	$(138,000)	$454,000	$1,793,000
Basic income (loss) per share	$0.11	$(0.04)	$0.12	$0.47

Diluted income (loss) per share	$0.10	$(0.04)	$0.11	$0.43

	April 29	July 29	October 28	January 31
2012				
Sales, net	$6,709,000	$6,421,000	$7,320,000	$9,157,000
Gross profit	$1,706,000	$1,417,000	$2,011,000	$3,361,000
Operating (loss) income	$(382,000)	$(221,000)	$336,000	$1,608,000
Net (loss) income	$(317,000)	$(167,000)	$146,000	$730,000
Basic (loss) income per share	$(0.08)	$(0.04)	$0.04	$0.19
Diluted (loss) income per share	$(0.08)	$(0.04)	$0.04	$0.18

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16. Subsequent Events

Merger Agreement

On April 19, 2013, the Company entered into an Agreement and Plan of Merger (the “Merger Agreement”) with TransDigm Group Incorporated (“TransDigm”), and Buccaneer Acquisition Sub Inc. (“Purchaser”), an indirect wholly-owned subsidiary of TransDigm. Pursuant to the Merger Agreement, and on the terms and subject to the conditions described in the Merger Agreement, TransDigm agreed to conduct a cash tender offer (the “Offer”) to purchase all of the Company’s issued and outstanding shares of common stock (the “Shares”), at a price of $7.75 per share in cash, without interest (less any applicable withholding taxes). Following the successful completion of the Offer, and subject to the terms and conditions of the Merger Agreement, Purchaser will be merged with and into the Company, with the Company surviving as an indirect wholly-owned subsidiary of TransDigm.

The obligation of TransDigm and Purchaser to consummate the Offer is subject to customary conditions, including but not limited to: (a) at least a majority of the outstanding Shares (determined on a fully-diluted basis) having been validly tendered and not withdrawn prior to the expiration of the Offer; and (b) there having occurred no Change in Recommendation (as defined in the Merger Agreement) by the Company’s Board of Directors. The Merger Agreement permits the Company to solicit alternative acquisition proposals from third parties for 40 days, until May 29, 2013. There is no assurance that this process will result in an alternative transaction.

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Loss from continuing operations	(6,571)	(10,608)	(12,170)	(13,608)	(8,174)	(2,201)	(2,541)
Loss from discontinued operations, net of income taxes			(1,904)	(5,738)	(3,650)	(486)	
Net loss	(6,571)	(10,608)	(14,074)	(19,346)	(11,824)	(2,687)	(2,541)
Preferred dividends and beneficial conversion charge[(1)]	(851)	(1,563)	(2,147)	(19,875)	(3,042)	(761)	(582)
Net loss attributable to common stockholders							

$ (7,422) $ (12,171) $ (16,221) $ (39,221) $ (14,866) $ (3,448) $ (3,123)

Basic and diluted loss per common share:

Loss from continuing operations attributable to common stockholders
$ $ $ $ $ $ $
Loss from discontinued operations attributable to common stockholders

Net loss attributable to common stockholders
$ $ $ $ $ $ $
Basic and diluted weighted average common shares outstanding

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	As of December 31,					As of March 31, 2010 (Unaudited)
	2005	2006	2007	2008	2009	
	(in thousands)					
Consolidated balance sheet data:						
Cash	$ 5,606	$ 7,638	$ 5,776	$ 516	$	$ 522
Total assets	12,107	20,904	21,909	30,570	22,368	24,722
Current portion of long-term debt	32	74	13	7,006	426	18,872
Long-term debt, net of current portion	43	13		5	14,403	2
Other long-term obligations	4			481	1,048	1,070

	Year Ended December 31,					Three Months Ended March 31, 2010
	2005	2006	2007	2008	2009	
	(in thousands, except location amounts) (Unaudited)					
Other information:						
Primo water bottle exchange locations at period end	300	2,300	4,700	6,400	7,000	7,020
Primo water bottle units sold	14	745	1,994	3,215	3,853	965
Primo water dispenser units sold			12	177	272	62

(1) In 2008, we recorded a non-cash beneficial conversion charge or deemed dividend of $17.6 million on our Series C preferred stock. This was a result of the adjustment of the conversion ratio on the Series C preferred stock based upon a formula taking into account our net sales for the year ending December 31, 2008, which resulted in a final conversion ratio of 1:1.92.

MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the section titled Selected Historical Consolidated Financial and Other Data and our financial statements and related notes appearing elsewhere in this prospectus. Our actual results could differ materially from those anticipated in the forward-looking statements included in this discussion as a result of certain factors, including, but not limited to, those discussed in the section of this prospectus titled Risk Factors.

Overview

Primo Water Corporation is a rapidly growing provider of three- and five-gallon purified bottled water and water dispensers sold through major retailers nationwide. Our business is designed to generate recurring demand for Primo purified bottled water through the sale of our innovative water dispensers. Once our bottled water is consumed using a water dispenser, empty bottles are exchanged at our recycling center displays, which provide a recycling ticket that offers a discount toward the purchase of a new bottle of Primo purified water. We have created a nationwide single-vendor water bottle exchange service for our retail customers that requires minimal customer management supervision and store-based labor and provides centralized billing and detailed performance reports. We deliver this service utilizing our current relationships with 55 independent bottlers and 27 independent distributors and our two Company-owned distribution operations covering portions of four states, which we refer to collectively as our national network . As of December 31, 2009, our water bottle exchange service and water dispensers were offered in each of the contiguous United States and located in approximately 7,000 and 5,500 retail locations, respectively. For 2007, 2008 and 2009, we generated net sales of $13.5 million, $34.6 million and $47.0 million, respectively. For the three months ended March 31, 2009 and 2010, we generated sales of $9.6 million and $8.8 million, respectively.

In this Management s Discussion and Analysis of Financial Condition and Results of Operations, when we refer to same store sales for our Exchange segment, we are comparing retail locations at which our water bottle exchange service had been available for at least 12 months at the beginning of the relevant period.

Business Segments

We manage our business primarily through two reporting segments: Primo Bottled Water Exchange (Exchange) and Primo Products (Products).

Our Exchange segment sells three- and five-gallon purified bottled water through retailers in each of the contiguous United States. We currently offer our exchange service at approximately 7,000 locations through point of purchase display racks and recycling centers that are prominently located at major retailers in space that is often underutilized. We service these retail locations through our national network of primarily independent bottlers and distributors.

Our Products segment sells water dispensers that are designed to dispense Primo and other dispenser-compatible bottled water. Our Products sales are primarily generated through major U.S. retailers. Our water dispensers are sold primarily through a direct-import model, where we recognize revenues for the sale of the water dispensers when title is transferred to our retailer customers. We support retail sell-through with limited domestic inventory.

We evaluate the financial results of these segments focusing primarily on segment net sales and segment income (loss) from operations before depreciation and amortization (segment income (loss) from operations). We utilize segment net sales and segment income (loss) from operations because we believe they provide useful information for

effectively allocating our resources between business segments, evaluating the health of our business segments based on metrics that management can actively influence and gauging our investments and our ability to service, incur or pay down debt.

Operating segments that do not meet quantitative thresholds for segment reporting are included in Other.

Cost of sales for Exchange consists of costs for bottling and related packaging materials and distribution costs for our bottled water. Cost of sales for Products consists of contract manufacturing, freight, duties and warehousing costs of our water dispensers.

Selling, general and administrative expenses for both segments consist primarily of personnel costs for sales, marketing, operations support and customer service, as well as other supporting costs for operating each segment.

Expenses not specifically related to operating segments are shown separately as Corporate. Corporate expenses are comprised mainly of compensation and other related expenses for corporate support, information systems, and human resources and administration. Corporate expenses also include certain professional fees and expenses and compensation of our Board of Directors.

Recent Transactions

In December 2009, we completed the divestiture of our former subsidiary, Prima Bottled Water, Inc. (Prima), by distributing the stock in Prima to our existing stockholders on a pro rata basis based upon each such stockholder s proportionate ownership of our common stock, Series A preferred stock and Series C preferred stock on an as-converted basis. The assets, liabilities and results of operations of Prima are accounted for as discontinued operations. For 2007, 2008 and 2009, we recognized losses from discontinued operations of $1.9 million, $5.7 million and $3.7 million, respectively. For the three months ended March 31, 2009 and 2010, we recognized losses from discontinued operations of $0.5 million and $0, respectively.

On June 1, 2010 we entered into an asset purchase with Culligan to purchase the Culligan Refill Business. See Culligan Refill Acquisition on page 82 for a more detailed description of this transaction.

Results of Operations

The following table sets forth our results of operations for the periods indicated:

	Years Ended December 31,			Three Months Ended March 31,	
	2007	2008	2009	2009	2010
				(Unaudited)	
			(in thousands)		
Consolidated statements of operations data:					
Net sales	$ 13,453	$ 34,647	$ 46,981	$ 9,567	$ 8,829
Operating costs and expenses:					
Cost of sales	11,969	30,776	38,771	7,652	6,922
Selling, general and administrative expenses	10,353	13,791	9,922	2,605	2,733
Depreciation and amortization	3,366	3,618	4,205	1,034	995
Total operating costs and expenses	25,688	48,185	52,898	11,291	10,650
Loss from operations	(12,235)	(13,538)	(5,917)	(1,724)	(1,821)
Interest (expense) and other income, net	65	(70)	(2,257)	(477)	(720)

Loss from continuing operations before income taxes	(12,170)	(13,608)	(8,174)	(2,201)	(2,541)
Provision for income taxes					
Loss from continuing operations	(12,170)	(13,608)	(8,174)	(2,201)	(2,541)
Loss from discontinued operations, net of income taxes	(1,904)	(5,738)	(3,650)	(486)	
Net loss	(14,074)	(19,346)	(11,824)	(2,687)	(2,541)
Preferred dividends and beneficial conversion charge	(2,147)	(19,875)	(3,042)	(761)	(582)
Net loss attributable to common stockholders	$ (16,221)	$ (39,221)	$ (14,866)	$ (3,448)	$ (3,123)

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The following table sets forth our results of operations expressed as a percentage of net sales for the periods indicated:

	Years Ended December 31,			Three Months Ended March 31,	
	2007	2008	2009	2009	2010
				(Unaudited)	
Consolidated statements of operations data:					
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%
Operating costs and expenses:					
Cost of sales	89.0	88.8	82.5	80.0	78.4
Selling, general and administrative expenses	77.0	39.8	21.1	27.2	31.0
Depreciation and amortization	25.0	10.5	9.0	10.8	11.2
Total operating costs and expenses	191.0	139.1	112.6	118.0	120.6
Loss from operations	(91.0)	(39.1)	(12.6)	(18.0)	(20.6)
Interest (expense) and other income, net	0.5	(0.2)	(4.8)	(5.0)	(8.2)
Loss from continuing operations before income taxes	(90.5)	(39.3)	(17.4)	(23.0)	(28.8)
Provision for income taxes					
Loss from continuing operations	(90.5)	(39.3)	(17.4)	(23.0)	(28.8)
Loss from discontinued operations, net of income taxes	(14.1)	(16.5)	(7.8)	(5.1)	
Net loss	(104.6)%	(55.8)%	(25.2)%	(28.1)%	(28.8)%

The following table sets forth our segment net sales and segment income (loss) from operations presented on a segment basis and reconciled to our consolidated loss from operations.

	Years Ended December 31,			Three Months Ended March 31,	
	2007	2008	2009	2009	2010
				(Unaudited)	
			(in thousands)		
Segment Net Sales					
Exchange	$ 10,875	$ 19,237	$ 22,638	$ 5,363	$ 5,541
Products	949	13,758	22,824	3,864	2,909
Other	1,818	1,874	1,611	386	383
Inter-company elimination	(189)	(222)	(92)	(46)	(4)
Total net sales	$ 13,453	$ 34,647	$ 46,981	$ 9,567	$ 8,829

Segment Income (Loss) from Operations					
Exchange	$ (2,834)	$ (1,267)	$ 3,374	$ 695	$ 758
Products	(631)	(1,447)	(272)	(20)	(61)
Other	(175)	(116)	(34)	(9)	36
Inter-company elimination		(13)	9		(2)
Corporate	(5,229)	(7,077)	(4,789)	(1,356)	(1,557)
Depreciation and amortization	(3,366)	(3,618)	(4,205)	(1,034)	(995)
Loss from operations	$ (12,235)	$ (13,538)	$ (5,917)	$ (1,724)	$ (1,821)

Three Months Ended March 31, 2010 Compared to Three Months Ended March 31, 2009

Net Sales. Net sales for the first quarter of 2010 decreased $0.7 million or 7.7% to $8.8 million from $9.6 million in the first quarter of 2009. The decrease in sales resulted primarily from a 24.7% decrease in Products sales offset by a 3.3% increase in Exchange sales.

Exchange. Exchange net sales increased $0.2 million or 3.3% to $5.5 million in the first quarter of 2010, representing 62.8% of our total net sales in the first quarter of 2010. The increase was due to an 8.6% increase in water bottle units sold to approximately 1.0 million units sold in the first quarter of 2010. The increase in units

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sold was driven by an 8.1% increase in selling locations to approximately 7,020 at March 31, 2010. Same store units increased 2.2% in the first quarter of 2010 compared to the first quarter of 2009.

The average price per unit decreased 4.8% in the first quarter of 2010 compared to the first quarter of 2009 as a result of a shift in mix of transactions to 73.3% exchange and 26.7% non-exchange transactions in the first quarter of 2010 compared to 68.0% exchange and 32.0% non-exchange transactions in the first quarter of 2009. The shift in the mix of transactions is due to the increase in the overall number of repeat consumers utilizing our three- and five-gallon bottled water exchange service. This shift in mix is also impacted by the number of new locations added during a period. Locations in new markets generally have a higher percentage of non-exchange transactions as we introduce our service to new consumers. We recognize approximately twice as much revenue on non-exchange transactions as we do on exchange transactions as a result of the discount provided to consumers for the return of an empty three- or five-gallon bottle in exchange for the purchase of a new three- or five-gallon bottle of purified water. Adding new locations at which our water bottle exchange service is offered is important to our strategy of penetrating more homes with our water dispensers as expanded locations and increased water bottle availability enhance the convenience of our service to consumers.

Products. Products net sales decreased $1.0 million or 24.7% to $2.9 million in the first quarter of 2010, representing 32.9% of our total net sales in the first quarter of 2010. Dispenser sales decreased approximately 14,000 units or 18.1% to approximately 62,000 units in the first quarter of 2010. We believe the decrease in sales and units in the first quarter 2010 is primarily a result of retailers reducing their inventory levels. Water dispenser home penetration is critical to the success of our strategy of increasing sales of our complementary recurring-revenue bottled water exchange service.

Gross Margin. Our overall gross margin, defined as net sales less cost of sales, as a percentage of net sales increased to 21.6% for the first quarter of 2010 from 20.0% for the first quarter of 2009.

Exchange. Gross margin as a percentage of net sales in our Exchange segment increased to 26.5% for the first quarter of 2010 from 25.8% in the first quarter of 2009 due primarily to benefits from the improvements in our supply chain, which were completed in 2009. We anticipate that gross margins will continue to see improvements as we realize the full benefits of these improvements. These benefits could be offset slightly if fuel prices continue to increase and effect freight cost negatively.

Products. Gross margin as a percentage of net sales in our Products segment decreased to 7.4% for the first quarter of 2010 from 8.6% in the first quarter of 2009 due primarily to the mix of dispensers sold in the first quarter of 2010. Our strategy is to sell our water dispensers at minimal operating profit in order to increase home penetration, which we believe will lead to increased recurring revenue, higher margin Exchange sales.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the first quarter of 2010 increased slightly by $0.1 million or 4.9% to $2.7 million from $2.6 million and, as a percentage of net sales, increased to 31.0% for the first quarter of 2010 from 27.2% for the first quarter of 2009.

Exchange. Selling, general and administrative expenses of our Exchange segment increased 3.1% to $0.7 million and, as a percentage of Exchange segment net sales was 12.8% in both the first quarter of 2010 and the first quarter of 2009.

Products. Selling, general and administrative expenses of our Products segment decreased 21.4% to $0.3 million in the first quarter of 2010. Selling, general and administrative expenses as a percentage of Products segment net sales increased to 9.5% for the first quarter of 2010 from 9.1% in the first quarter of 2009. The increase as a percentage of Products segment net sales is a result of the 24.7% decrease in Product net sales.

Other. Other selling, general and administrative expenses, which include our Other segment and Corporate, increased $0.2 million or 11.7% to $1.8 million in the first quarter of 2010 from $1.6 million in the first quarter of 2009, and as a percentage of consolidated net sales increased to 19.8% for the first quarter of 2010 from 16.4% in the first quarter of 2009. We expect to incur about $1.0 million annually in additional costs as a public company related to compliance, reporting and insurance.

Depreciation and Amortization. Depreciation and amortization decreased 3.8% to $1.0 million in the first quarter 2010.

Interest (Expense) and Other Income, Net. Net interest expense for the first quarter of 2010 increased to $0.7 million from $0.5 million in the first quarter of 2009. The increase is a result of an increase in the use of debt to fund business operations as well as the higher interest rate on our 2011 Notes.

Preferred Dividends and Beneficial Conversion Charge. Dividends on our Series B preferred stock decreased $0.2 million to $0.6 million in the first quarter of 2010 from $0.8 million in first quarter of 2009. In January 2009, we offered holders of our Series B preferred stock the option to suspend their current cash dividend payment of 10% in exchange for a dividend accrual of 15% for 2009. In January 2010, the dividend accrual was reduced to 10% with no cash dividend until the Series B preferred stock is redeemed. Cash dividends paid on our Series B preferred stock during the first quarter of 2010 and the first quarter of 2009 were $0.2 million and $0.6 million, respectively. At March 31, 2010 the accrued and unpaid dividends on our Series B preferred stock is $2.7 million, which is included in accrued expenses and other current liabilities in the consolidated balance sheet.

Year Ended December 31, 2009 Compared to Year Ended December 31, 2008

Net Sales. Net sales for 2009 increased $12.3 million or 35.6% to $47.0 million from $34.6 million in 2008. The increase in sales resulted primarily from a 65.9% increase in Products sales and a 17.7% increase in Exchange sales.

Exchange. Exchange net sales increased $3.4 million or 17.7% to $22.6 million in 2009, representing 48.2% of our total net sales in 2009. The increase was due to an increase in water bottle units sold of approximately 0.6 million units or 19.8% to 3.9 million units sold in 2009. The increase in units sold was driven by a same store sales increase of 7.9% as well as an 8.3% increase in selling locations to approximately 7,000 at December 31, 2009. We believe the increase in same store sales is primarily a result of two factors: first, the increase in water dispenser sales results in an increasing number of consumers of three- and five-gallon bottled water and second, as more consumers become aware of and participate in our exchange program at a particular selling location, the number of water bottle units sold at that location typically increases over comparable prior periods. During 2009, we added approximately 600 selling locations as a result of both adding new retail customers and increased penetration with our existing retail customers. The average price per unit decreased 1.7% in 2009 compared to 2008 as a result of a shift in mix of transactions to 70.9% exchange and 29.1% non-exchange transactions in 2009 compared to 63.2% exchange and 36.8% non-exchange transactions in 2008. The shift in the mix of transactions is due to the increase in the overall number of repeat consumers utilizing our three- and five-gallon bottled water exchange service compared to the number of consumers that are new to our service. We anticipate the shift in mix towards a higher percentage of exchange transactions to continue as the overall number of consumers utilizing our exchange program continues to grow. We recognize approximately twice as much revenue on non-exchange transactions as we do on exchange transactions as a result of the discount provided to consumers for the return of an empty three- or five-gallon bottle in exchange for the purchase of a new three- or five-gallon bottle of purified water. Adding new locations at which our water bottle exchange service is offered is important to our strategy of penetrating more homes with our water dispensers as expanded locations and increased water bottle availability enhance the convenience of our service to consumers.

Products. Products net sales increased $9.1 million or 65.9% to $22.8 million in 2009, representing 48.6% of our total net sales in 2009. Dispenser sales increased 95,000 units or 53% to approximately 272,000 units in 2009. The increase in sales and units in 2009 is primarily a result of a greater than 100% increase in the number of retail locations offering our dispensers to approximately 5,500 at December 31, 2009. In addition, we successfully launched several new water dispenser models which accounted for approximately 48% of the total units sold in 2009. We anticipate continuing to introduce and offer new water dispenser models. Water dispenser home penetration is critical to the

success of our strategy of increasing sales of our complementary recurring-revenue bottled water exchange service.

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Gross Margin. Our overall gross margin, defined as net sales less cost of sales, as a percentage of net sales increased to 17.5% for 2009 from 11.2% for 2008.

Exchange. Gross margin as a percentage of net sales in our Exchange segment increased to 26.6% for 2009 from 15.2% in 2008 due primarily to decreased freight costs as a result of the addition of bottling and distribution capabilities during 2008 for which we received a full-year benefit in 2009. With these additions we believe we have sufficient bottling and distribution capabilities to service our continued growth. We anticipate slight improvements in gross margin for our Exchange segment for 2010 as we further benefit from improvements in our supply chain and realize efficiencies from our business model in which many of our variable costs are fixed.

Products. Gross margin as a percentage of net sales in our Products segment improved to 5.6% for 2009 from 0.5% in 2008 due primarily to improved pricing from retailers. Our strategy is to sell our water dispensers at minimal operating profit in order to increase home penetration, which we believe will lead to increased recurring-revenue, higher margin Exchange sales.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for 2009 decreased $3.9 million or 28.1% to $9.9 million from $13.8 million and, as a percentage of net sales, decreased to 21.1% for 2009 from 39.8% for 2008.

Exchange. Selling, general and administrative expenses of our Exchange segment decreased $1.5 million or 36.8% to $2.6 million from $4.2 million and as a percentage of Exchange segment net sales decreased to 11.7% in 2009 from 21.8% in 2008. The decrease is due to lower employee-related costs as a result of a reduction in headcount of seven employees as well as reduced levels of consulting fees and related travel and benefit costs resulting in approximately $1.0 million of the overall reduction of selling, general and administrative expenses. The additional personnel resources were related to our efforts in 2008 to expand our supply chain with more bottling and distribution capacity. During 2009 we were able to reduce these personnel resources when our supply chain reached what we believe to be an appropriate size. We were able to significantly grow our Exchange segment net sales and gross margins in 2009 despite the reduction in selling, general and administrative expenses.

Products. Selling, general and administrative expenses of our Products segment decreased as a percentage of Products segment net sales to 6.8% in 2009 from 11.1% in 2008. Our Products segment was able to significantly increase sales without the need for additional headcount or selling, general and administrative costs.

Other. Other selling, general and administrative expenses for 2009, which includes our Other segment and Corporate, decreased $2.4 million or 29.1% to $5.7 million from $8.1 million, and as a percent of consolidated net sales decreased to 12.2% for 2009 from 23.3% in 2008. The decrease is primarily due to lower employee-related costs as a result of a reduction in headcount of nine employees as well as reduced levels of consulting fees and related travel and benefit costs resulting in about $1.6 million of the overall reduction of selling, general and administrative expenses. The additional resources were related to our efforts in 2008 to expand our information system and financial infrastructure as well as our efforts to establish new business segments. While we do not expect to incur significant additional costs connected with the growth of our businesses in 2010, we do expect to incur about $1.0 million in additional costs as a public company related to compliance, reporting and insurance.

Depreciation and Amortization. Depreciation and amortization increased $0.6 million or 16.2% to $4.2 million in 2009 from $3.6 million in 2008. The increase is the result of a full year of depreciation on the $8.3 million of capital expenditures in 2008.

Interest (Expense) and Other Income, Net. Net interest expense for 2009 increased to $2.3 million from $70,000 in 2008 as a result of increased use of debt to fund business operations. We expect the proceeds from this offering to

repay debt and lower future interest cost relative to that experienced during 2009.

Preferred Dividends and Beneficial Conversion Charge. Dividends on our Series B preferred stock increased $0.7 million to $3.0 million in 2009 from $2.3 million in 2008. In January 2009, we offered holders of our Series B preferred stock the option to suspend their current cash dividend payment of 10% in exchange for a

dividend accrual of 15% for 2009. Cash dividends paid on our Series B preferred stock during 2009 and 2008 were $1.3 million and $2.3 million, respectively. At December 31, 2009 and 2008 the accrued and unpaid dividends on our Series B preferred stock were $2.4 million and $0.6 million, respectively, which is included in accrued expenses and other current liabilities in the consolidated balance sheet. Our Series C preferred stock is convertible into common stock at a ratio of 1:1.92, which was based upon a formula taking into account sales for 2008, compared to the original conversion ratio of 1:1. The change in the conversion resulted in a $17.6 million beneficial conversion or deemed dividend on the Series C preferred stock for 2008, which is included in the $19.9 million preferred dividends and beneficial conversion charge in 2008.

Year Ended December 31, 2008 Compared to Year Ended December 31, 2007

Net Sales. Net sales for 2008 increased $21.2 million or 157.5% to $34.6 million from $13.5 million in 2007. The increase in net sales resulted primarily from a 1,349.7% increase in Products sales and a 76.9% increase in Exchange sales.

Exchange. Exchange net sales increased $8.3 million to $19.2 million in 2008, representing 55.5% of our total net sales in 2008. The increase was due to an increase in water bottle units sold of 1.2 million or 61.2% to 3.2 million units sold in 2008. The increase in units was driven by a same store sales increase of 22.0% as well as a 36.1% increase in selling locations to approximately 6,400 selling locations at December 31, 2008. The average price per unit increased 9.7% in 2008 primarily as a result of a price increase implemented in mid-2008.

Products. Products net sales increased $12.8 million to $13.8 million, representing 39.7% of our total net sales in 2008. The increase is due to the successful launch of our Products business segment in late 2007. Product sales increased by approximately 165,000 units to approximately 177,000 units sold in 2008.

Gross Margin. Our overall gross margin, defined as net sales less cost of sales, as a percentage of net sales increased to 11.2% for 2008 from 11.0% for 2007.

Exchange. Gross margin as a percentage of net sales in our Exchange segment increased to 15.2% for 2008 from 6.1% in 2007 due primarily to decreased freight costs as a result of the addition of 28 bottlers and ten distributors in 2008.

Products. Gross margin as a percentage of net sales in our Products segment improved to 0.5% for 2008 from (23.2)% in 2007 due primarily to limited sales volume in 2007.

Selling, General and Administrative Expenses. Selling, general and administrative expenses, excluding impairment charges, for 2008 increased $3.4 million or 33.2% to $13.8 million from $10.4 million and, as a percentage of net sales, decreased to 39.8% for 2008 from 77.0% for 2007.

Exchange. Selling, general and administrative expenses of our Exchange segment increased $0.7 million or 19.5% to $4.2 million from $3.5 million and as a percentage of Exchange segment net sales decreased to 21.8% in 2008 from 32.2% in 2007. The increase is primarily due to higher employee-related costs as a result of headcount additions, consulting fees and related travel and benefit costs resulting in about $0.3 million of the overall increase. The additional personnel and resources were related to our efforts to expand our supply chain with more bottling and distribution capacity. Selling, general and administrative expenses as a percentage of Exchange segment net sales decreased significantly as we grew net sales at a faster rate than our expense growth.

Products. Selling, general and administrative expenses of our Products segment increased $1.1 million or 270.3% to $1.5 million from $0.4 million and as a percentage of Products segment net sales to 11.1% in 2008 from 43.3% in 2007. The increase is primarily due to increases in employee headcount resulting from our expanded product line and

significant increase in net sales in 2008.

Other. Other selling, general and administrative expenses for 2008, which includes our Other segment and Corporate, increased $1.6 million or 24.5% to $8.1 million from $6.5 million, and as a percentage of consolidated net sales decreased to 23.3% for 2008 from 48.3% in 2007. The increase is primarily due to higher employee-related costs as a result of additional headcount, consulting fees and related travel and benefit costs

related to our efforts in 2008 to expand our information system and financial infrastructure as well as our efforts to establish new business segments.

Depreciation and Amortization. Depreciation and amortization increase $0.2 million or 7.5% to $3.6 million in 2008 from $3.4 million in 2007.

Interest Expense and Other Income, Net. Net interest and other income for 2008 decreased to an expense of $70,000 from income of $65,000 in 2007 as a result of the use of debt to fund business operations, which were primarily funded with equity in 2007.

Preferred Dividends and Beneficial Conversion Charge. Dividends on our Series B preferred stock increased $0.2 million to $2.3 million in 2008 from $2.1 million in 2007. At both December 31, 2008 and 2007, the accrued and unpaid dividends on our Series B preferred stock were $0.6 million, which is included in accrued expenses and other current liabilities in the consolidated balance sheet. Our Series C preferred stock is convertible into common stock at a ratio of 1:1.92, which was based upon a formula taking into account sales for 2008, compared to the original conversion ratio of 1:1. The change in the conversion resulted in a $17.6 million beneficial conversion or deemed dividend on the Series C preferred Stock for 2008, which is included in the $19.9 million of preferred dividends and beneficial conversion charge in 2008.

Liquidity and Capital Resources

The following table shows the components of our cash flows for the periods presented:

	Year Ended December 31,			Three Months Ended March 31,	
	2007	**2008**	**2009**	**2009**	**2010**
				(unaudited)	
		(in thousands)			
Net cash provided by (used in):					
Operating activities	$ (6,752)	$ (11,832)	$ (1,972)	$ (2,279)	$ (1,666)
Investing activities	(4,992)	(9,628)	(2,450)	(635)	(571)
Financing activities	12,529	24,361	6,274	3,609	2,759

Since inception, we have financed our operations primarily through the sale of preferred stock, the issuance of long term debt and borrowings under credit facilities. At March 31, 2010, our principal sources of liquidity were accounts receivable, net of allowance for doubtful accounts, of $3.0 million compared to cash of $0.5 million and borrowing availability under our current senior revolving credit facility.

During the first quarter of 2010, our primary source of capital was proceeds from borrowings under our current senior revolving credit facility, which had a balance of $4.4 million at March 31, 2010. During 2009, the primary source of capital was proceeds from the issuance of long term debt and, as of December 31, 2009, we had an outstanding debt balance of $14.8 million, net of a $0.6 million discount. During 2008 and 2007, our primary source of capital was the proceeds of preferred stock issuances of $19.6 million and $14.1 million, respectively. Additionally, during 2008 we made borrowings under our current senior revolving credit facility, which had a balance of $7.0 million at December 31, 2008.

Net Cash Flows from Operating Activities

During the first quarter of 2010, we used $1.7 million in operations primarily as a result of $2.5 million of loss from continuing operations, offset by non-cash depreciation and amortization of $1.0 million. During the first quarter of 2009, we used $2.3 million in operating activities as a result of $2.2 million of loss from continued operations.

Net cash used in operating activities was $2.0 million for 2009, $11.8 million for 2008 and $6.8 million for 2007. For 2009, net cash used in operations was primarily the result of $8.2 million of loss from continuing operations, partially offset by non-cash depreciation and amortization of $4.2 million, non-cash interest expense of $0.7 million related to our long term debt issuances and reduction in working capital components of $0.8 million. For 2008, net cash used in operations was primarily the result of $13.6 million of loss from continuing operations, partially offset by depreciation and amortization of $3.6 million. Additional working capital for accounts receivable and inventory due to revenue growth resulted in a use of cash of $1.9 million and $1.3 million, respectively, and was partially offset by an increase in accounts payable of $1.1 million.

For 2007, net cash used in operations was primarily the result of $12.2 million of loss from continuing operations, partially offset by depreciation and amortization of $3.4 million and the increase of accounts payable and accrued expenses of $1.0 million and $1.3 million, respectively.

Net Cash Flows from Investing Activities

Our primary investing activities are capital expenditures for property, equipment and bottles. Our capital expenditures in the past have been primarily for the installation of our recycle centers and display racks at new locations that offer our water bottle exchange service as well as related transportation racks and bottles. We also invest in technology infrastructure to manage our national network.

During the first quarter of 2010 and 2009, cash flows from investing activities primarily consisted of capital expenditures for property, equipment and bottles of $0.6 million and $0.6 million, respectively. During 2009, 2008 and 2007 cash flows from investing activities included capital expenditures for property and equipment and bottles of $2.4 million, $9.4 million and $5.0 million, respectively.

Net Cash Flows from Financing Activities

During the first quarter of 2010, cash provided by financing activities was primarily from borrowings under our current senior revolving credit facility of $3.9 million offset by dividends paid of $0.2 million and equity issuance costs of $0.9 million. During the first quarter of 2009, cash provided by financing activities was primarily from the issuance of long term debt of $10.0 million offset by payments on our current senior revolving credit facility of $5.0 million and debt issuance costs of $0.6 million.

For 2009, financing activities were primarily the issuance of long term debt of $20.4 million that was partially offset by payments of $6.6 million on our current senior revolving credit facility, payments of $5.4 million related to other long-term debt, Series B preferred stock dividend payments of $1.3 million and payment of debt issuance costs of $0.6 million. The cash component of our Series B preferred stock dividends was partially reduced in 2009 and accrued as opposed to paid currently. Additionally, the cash dividends paid will be further reduced for 2010 to approximately $0.2 million.

For 2008, financing activities were primarily the issuance of preferred stock of $19.6 million and borrowings of $7.0 million on our current senior revolving credit facility that were partially offset by payments of $2.3 million of Series B preferred stock dividends. For 2007, financing activities were primarily the issuance of preferred stock of $14.1 million that was partially offset by $1.6 million of Series B Preferred Stock dividend payments.

Current Senior Revolving Credit Facility

We originally entered into a revolving credit facility with Wachovia Bank National Association in June 2005 and have subsequently amended the facility and extended the term to January 30, 2011. The current facility commitment is $10.0 million, allows for up to a $3.0 million overadvance line (the Overadvance Line) and is subject to a customary borrowing base calculation for advances. Interest on the outstanding borrowings under the current senior revolving credit facility is payable quarterly at our option at: (i) the greater of (A) the LIBOR Market Index Rate or (B) 2.0% plus in either such case the applicable margin or (ii) the greater of (X) the Federal Funds Rate plus 0.50% or (Y) the bank s prime rate plus in either such case the applicable margin. At

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December 31, 2009 and 2008, the interest rate on the outstanding balance under the facility was at the bank s prime rate plus 2.50% and 0.75%, respectively (5.75% at December 31, 2009 and 4.00% at December 31, 2008). At March 31, 2010, the interest rate on outstanding borrowings was at the bank s prime rate plus 1.00% (4.25%) and the availability under the facility was $1.6 million. Effective with a June 2010 amendment, the applicable margin was increased to 4.00% for a Libor Market Index Rate loan (5.00% when borrowings under the Overadvance Line are outstanding) and 2.00% for a loan provided at the Federal Funds Rate plus 0.50% or the bank s prime rate (3.00% when borrowings under the Overadvance Line are outstanding). After giving effect to the June 2010 amendment, the interest rate on outstanding borrowings was 5.25%.

We are required to pay a fee per annum equal to 3.50% of the outstanding amount of letters of credit issued under the current senior revolving credit facility. In addition, there is a fee of 0.50% on the unused portion of the revolver lending commitment. At March 31, 2010, there were outstanding letters of credit totaling approximately $2.4 million.

The current senior revolving credit facility contains various conditions for extensions of credit and restrictive covenants including minimum quarterly EBITDA, gross revenue and net worth requirements. Substantially all of our assets are pledged as collateral to borrowings under the current senior revolving credit facility. We were in default under our minimum quarterly EBITDA and net worth covenants as of March 31, 2010, but have received a waiver from our lender. In connection with the June 2010 amendment these financial covenants were amended.

Finally, Billy Prim, our Chief Executive Officer, has agreed to personally guarantee our borrowings with respect to the Overadvance Line in an amount up to $3.0 million. As an inducement to Mr. Prim to guarantee the $3.0 million Overadvance Line, the Company will issue Mr. Prim $150,000 of restricted stock with the per share value equal to (i) the initial public offering price or (ii) if the initial public offering does not occur, the lesser of (a) $1.23 per share (the fair value of our common stock based upon the valuation we obtained from a third party in December 2009) or (b) the price per share we issue equity in our next financing round. The restricted stock will be issued within 30 days after our initial public offering or the closing of our next financing round and will vest in full on January 2, 2011. The award of restricted stock was approved by the independent members of the board of directors and the amount of the award was based upon 5% of the guaranteed obligations (which the board members believed was an appropriate amount in light of their experience with similar transactions and representative of a 2.5% commitment fee and a 2.5% draw-down fee).

14% Subordinated Convertible Notes due March 31, 2011

In December 2009, we issued our 14% subordinated convertible notes due March 31, 2011 (2011 Notes) to 28 investors, including existing stockholders, affiliates of existing stockholders and senior management. The 2011 Notes have a total face value of $15.0 million and are subordinated to our current senior revolving credit facility. The 2011 Notes pay quarterly interest at a rate of 14% per annum. The terms of the 2011 Notes provide the noteholders the right to sell their 2011 Notes to us at an amount equal to the unpaid principal balance plus all unpaid interest that has accrued through the date of redemption upon the occurrence of an initial public offering of our common stock resulting in net proceeds to us of at least $30.0 million. We intend to use proceeds of this offering to repay the 2011 Notes.

Warrants to purchase 1,111,109 shares of our common stock were issued in connection with the 2011 Notes. The initial fair value of the warrants is $0.6 million and resulted in an original issue discount on the 2011 Notes which will be amortized as interest expense over the term of the 2011 Notes. The fair value of the warrants is included in other long-term liabilities in the consolidated balance sheet and will be adjusted periodically until such time as the exercise price becomes fixed at which time the then fair value will be reclassified as a component of stockholders equity (deficit).

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New Senior Revolving Credit Facility

In connection with the closing of this offering and the completion of the Culligan Refill Acquisition, we intend to enter into a new $40.0 million senior revolving credit facility that will replace our current senior revolving credit facility.

Adequacy of Capital Resources

Our future capital requirements may vary materially from those now anticipated and will depend on many factors, including acquisitions of other businesses, the rate of growth in new locations and related display and rack costs, cost to develop new water dispensers, sales and marketing resources needed to further penetrate our markets, the expansion of our operations in the United States and the response of competitors to our solutions and products. Historically, we have experienced increases in our capital expenditures consistent with the growth in our operations and personnel, and we anticipate that our expenditures will continue to increase as we grow our business.

While we had no material commitments for capital expenditures as of March 31, 2010, we do anticipate incurring between $2.0 million and $4.0 million of capital expenditures related to our anticipated growth in exchange locations and new water dispenser lines for the remainder of 2010. Upon completion of the Culligan Refill Acquisition, we estimate that we will incur between $1.0 million and $3.0 million of additional capital expenditures in 2010 related to current locations and future customer growth in connection with the Culligan Refill Business. In addition, we anticipate that we may incur additional expenses related to the integration of the Culligan Refill Acquisition.

In addition, following the completion of this offering, we expect to incur approximately $1.0 million per year in increased costs as a public company related to compliance, reporting and insurance. Mitigating these additional expenses, our Series B preferred stock dividends will terminate upon the redemption and conversion of the Series B preferred stock upon the completion of this offering.

Following the completion of this offering and our entering into our new senior revolving credit facility and the application of the proceeds therefrom as described herein (including consummation of the Culligan Refill Acquisition), we anticipate having $ in availability under our new senior revolving credit facility. We believe our cash, the proceeds from this offering, funds available under our new senior revolving credit facility and future cash flows from our operations will be sufficient to meet our currently anticipated working capital and capital expenditure requirements for at least the next twelve months.

During the last three years, trends and conditions in the retail environment and credit markets, inflation and changing prices have not had a material effect on our business and we do not expect that these trends and conditions, inflation or changing prices will materially affect our business in the foreseeable future.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt. Additionally, we are not a party to any derivative contracts or synthetic leases.

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Contractual and Commercial Commitment Summary

Our contractual obligations and commercial commitments as of December 31, 2009 are summarized below:

		Payments Due by Period			
Contractual Obligations[1]	Total	Less Than 1 Year	1-3 Years (in thousands)	3-5 Years	More Than 5 Years
Long-term debt obligations	$ 15,000	$	$ 15,000	$	$
Capital lease obligations	7	4	3		
Operating lease obligations	2,008	691	841	394	82
Current senior revolving credit facility	423	423			
Total	$ 17,438	$ 1,118	$ 15,844	$ 394	$ 82

(1) No amounts are included herein with respect to dividends related to our Series B preferred stock as all such shares will be converted or redeemed in connection with this offering.

Inflation

During the last three years, inflation and changing prices have not had a material effect on our business and we do not expect that inflation or changing prices will materially affect our business in the foreseeable future.

Quantitative and Qualitative Disclosures About Market Risk

For fixed rate debt, interest rate changes affect the fair value of financial instruments but do not impact earnings or cash flows. Conversely, for floating rate debt, interest rate changes generally do not affect the fair market value but do impact future earnings and cash flows, assuming other factors are held constant. The recorded carrying amounts of cash and cash equivalents approximate fair value due to their short maturities.

We are exposed to market risk related to changes in interest rates on borrowings under our current senior revolving credit facility. Our current senior revolving credit facility bears interest based on LIBOR and the prime rate, plus an applicable margin. To quantify our exposure to interest rate risk, a 100 basis point increase in interest rates would have increased interest expense for the years ended December 31, 2007, 2008, and 2009 by approximately $8,000, $29,000 and $132,000, respectively. Actual changes in interest rates may differ materially from the hypothetical assumptions used in computing this exposure.

Seasonality

We have experienced and expect to continue to experience seasonal fluctuations in our sales and operating income. Our sales and operating income have been highest in the spring and summer, and lowest in the fall and winter. Our Exchange segment, which generally enjoys higher margins than our Products segment, experiences higher sales and operating income in the spring and summer. Our Products segment had historically experienced higher sales and operating income in spring and summer, however, we believe the seasonality of this segment will be more dependent

on retailer inventory management and purchasing cycles and not correlated to weather. Sustained periods of poor weather, particularly in the spring and summer, can negatively impact our sales in our higher margin Exchange segment. Accordingly, our results of operations in any quarter will not necessarily be indicative of the results that we may achieve for a fiscal year or any future quarter.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements and related notes, which have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of our financial statements in conformity with GAAP requires us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions used to determine certain amounts that affect the financial

statements are reasonable, based on information available at the time they are made. To the extent there are material differences between these estimates, judgments and assumptions and actual results, our consolidated financial statements may be affected. Some of the more significant estimates include allowances for doubtful accounts, valuation of inventories, depreciation, valuation of deferred taxes and allowance for sales returns.

Revenue Recognition. Revenue is recognized for the sale of three- and five-gallon purified bottled water upon either the delivery of inventory to the retail stores or the purchase by the consumer. Revenue is either recognized as an exchange transaction (where a discount is provided on the purchase of a three- or five-gallon bottle of purified water for the return of an empty three- or five-gallon bottle) or a non-exchange transaction. Revenues on exchange transactions are recognized net of the exchange discount. Our water dispensers are sold primarily through a direct-import model, where we recognize revenue when title is transferred to our retail customers. We have no contractual obligation to accept returns of water dispensers nor do we guarantee water dispenser sales. However, we will at times accept returns or issue credits for water dispensers that have manufacturer defects or that were damaged in transit. Revenues of water dispensers are recognized net of an estimated allowance for returns using an average return rate based upon historical experience. In addition, we offer certain incentives such as coupons and rebates that are netted against and reduce net sales in the consolidated statements of operations. Historically, these incentives have not been material to the overall consolidated results of operations.

Allowance for Doubtful Accounts. We maintain an allowance for doubtful accounts for estimated losses resulting from our retail customers inability to pay us. The allowance for doubtful accounts is based on a review of specifically identified accounts in addition to an overall aging analysis. Judgments are made with respect to the collectability of accounts receivable based on historical experience and current economic trends. Actual losses could differ from those estimates.

Long-Lived Assets. We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset at the date it is tested for recoverability, whether in use or under development. An impairment loss is measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value. We recorded an impairment charge in 2008 of $98,000, related to display racks no longer in use and to be disposed.

Income Taxes. We account for income taxes using the asset and liability method, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance to the extent that utilization is not presently more likely than not.

Effective January 1, 2007, we adopted the provisions of Accounting Standards Codification (ASC) 740-10, *Income Taxes*. Previously, we had accounted for tax contingencies in accordance with ASC 450-10, *Contingencies*. As required by ASC 740-10, we recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the more-likely-than-not threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50 percent likelihood of being realized upon ultimate settlement with the relevant tax authority. At the adoption date, we applied ASC 740-10 to all tax positions for which the statute of limitations remained open. The implementation of ASC 740-10 did not have a material impact on our consolidated financial statements.

Stock-Based Compensation. We account for our stock-based employee and director compensation plans in accordance with ASC 718, *Compensation-Stock Compensation*. ASC 718 requires recognition of the cost of employee services

received in exchange for an award of equity instruments in the financial statements over the period the employee is required to perform the services in exchange for the award (presumptively the vesting period). In 2007, 2008 and 2009 compensation expense related to stock options was approximately $157,000, $215,000 and $298,000 and is included in selling, general and administrative expenses from continuing operations, respectively, and approximately $25,000, $61,000 and $80,000 is included in discontinued operations, respectively. For the

three months ended March 31, 2010, compensation expense related to stock options was approximately $118,000, which is included in selling, general and administrative expenses from continuing operations.

We measure the fair value of each stock option grant at the date of grant using the Black-Scholes option pricing model. The weighted-average fair value per share of the options granted during 2007, 2008 and 2009 was $0.67, $0.83 and $0.49, respectively. The weighted-average fair value per share of the options granted during the three months ended March 31, 2010 was $0.59. The following assumptions were used in arriving at the fair value of options granted:

	Year Ended December 31,			Three Months Ended March 31,
	2007	2008	2009	2010
Risk-free interest rate	4.6%	3.2%	2.0%	2.8%
Expected life of options in years	6.3	5.9	5.5	6.3
Estimated volatility	45.0%	39.0%	39.0%	45.5%
Dividend yield				

The risk-free interest rate is based on the implied yield available on U.S. Treasury zero-coupon issues with a remaining term approximately equal to the expected life of our stock options. The estimated pre-vesting forfeiture rate is based on our historical experience. The expected term of the options is based on evaluations of historical and expected future employee exercise behavior. As a non-public entity, historic volatility is not available for our shares. As a result, we estimated volatility based on a peer group of companies, which we believe collectively provide a reasonable basis for estimating volatility. We intend to continue to consistently use the same group of publicly traded peer companies to determine volatility in the future until sufficient information regarding volatility of our share price becomes available or the selected companies are no longer suitable for this purpose. We do not expect to declare dividends on our common stock in the foreseeable future. As of each stock option grant date, we considered the fair value of the underlying common stock, determined as described below, in order to establish the option exercise price.

During 2009 a total of 142,000 common stock options were granted, all on one date during the quarter ended March 31, 2009, at an exercise price of $1.25 per share. The estimated fair value of our common stock on the issuance date was $1.25 per share.

During the three months ended March 31, 2010, a total of 325,000 common stock options were granted at an exercise price of $1.23 per share. The estimated fair value of our common stock on the issuance date was $1.23 per share. In addition, we granted 1,102,500 shares of restricted stock that generally cliff-vest over a three-year period and we recognized compensation expense of $40,000 related to these awards, which is included in selling, general, and administrative expenses from continuing operations.

At March 31, 2010, we had approximately 3.2 million stock options outstanding, approximately 2.6 million of which were vested with an intrinsic value of $, and approximately 0.6 million of which were unvested with an intrinsic value of $. The intrinsic value reflects the amount by which $ (the midpoint of our estimated public offering price) exceeds the exercise price of the outstanding stock options.

In April 2010, the Board of Directors approved the 100% vesting of all unvested stock option awards upon the successful completion of an initial public offering of the Company s common stock. All unrecognized compensation cost at the time the stock option awards become fully vested would then be expensed.

Significant Factors Used in Determining Fair Value of Our Common Stock. The fair value of the shares of common stock that underlie the stock options we have granted has historically been determined by our board of directors based upon information available to it at the time of grant. Because, prior to this offering, there has been no public market for our common stock, our board of directors has determined the fair value of our common stock by utilizing, among other things, recent or contemporaneous valuation information from negotiated equity transactions with third parties or third party valuations. The valuation information included reviews of our business

and general economic, market and other conditions that could be reasonably evaluated at that time, including our financial results, business agreements, intellectual property and capital structure. These valuation approaches are based on a number of assumptions, including our future sales and industry, general economic, market and other conditions that could reasonably be evaluated at the time of the valuation.

For the 142,000 stock options granted on one date in the first quarter of 2009, the fair value of our common stock was determined by the board of directors to be $1.25 per share. The fair value was based in part upon the finalization of the conversion ratio of the Series C Preferred Stock on December 31, 2008. The Series C Preferred Stock was issued in an arms-length transaction primarily to unrelated third parties in 2008 with an initial conversion to common stock ratio of 1:1 or $2.40 per share. However, the Series C Preferred Stock contained a beneficial conversion feature that was negotiated with the primarily unrelated third parties that adjusted and was finalized based upon the consolidated net sales for the year ending December 31, 2008. The final conversion ratio was 1:1.92 or $1.25 per share. In addition, the board of directors considered the Company s most recent independent valuation and then current expectations of the Company s future performance in determining that $1.25 per share was a reasonable fair valuation of common stock at December 31, 2008 and that there were not any significant changes in the business or results of operations from December 31, 2008 to the date in the first quarter of 2009 the stock options were issued that would change that estimated fair value.

For the 325,000 stock options and 1,102,500 restricted stock awards granted during the first quarter of 2010, the fair value of our common stock was determined by the board of directors to be $1.23 per share. The fair value was based upon a valuation obtained by the Company from an unrelated party in December 2009 that determined the fair value of the Company s common stock to be $1.23 per share. The fair value method utilized by the unrelated party was the income approach. The income approach recognizes that the current value is premised upon the expected receipt of future economic benefits or cash flows. The fair value is developed utilizing management s estimates of expected future cash flows and discounting them to their present value utilizing a discount rate of 20.0%. In addition, there were not any significant changes in the business, results of operations or expected future cash flows from the valuation date in December 2009 to the dates in the first quarter of 2010 the stock options and restricted stock awards were granted that would change the estimated fair value.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued authoritative guidance which established the Accounting Standards Codification (ASC or Codification) as the source of authoritative GAAP recognized by the FASB to be applied to nongovernmental entities, and rules and interpretive releases of the SEC as authoritative GAAP for SEC registrants. The Codification supersedes all existing non-SEC accounting and reporting standards upon its effective date and, subsequently, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. The guidance is not intended to change or alter existing GAAP. The guidance became effective in our fourth quarter of 2009. The guidance did not have an impact on our consolidated financial position, results of operations or cash flows.

In May 2009, the FASB issued authoritative guidance on the accounting for and disclosure of events that occur after the balance sheet date. This guidance was effective for interim and annual financial periods ending after June 15, 2009. This guidance was amended in February 2010. It requires an entity that is a SEC filer to evaluate subsequent events through the date that the financial statements are issued. The adoption did not impact our consolidated financial position, results of operations or cash flows.

In January 2010, the FASB issued guidance, which clarifies that the stock portion of a distribution to stockholders that allows them to receive cash or stock with a potential limitation on the total amount of cash that all stockholders can elect to receive in the aggregate is considered a share issuance that is reflected in earnings per share prospectively and

is not a stock dividend. This update is effective for our first quarter of 2010. The adoption is not expected to have a material impact on our consolidated financial position results of operations or cash flows.

In January 2010, the FASB issued guidance that clarifies ASC 810 implementation issues relating to a decrease in ownership of a subsidiary that is a business or non-profit activity. This amendment affects entities that have previously adopted ASC 810-10. This update is effective for our first quarter of 2010. The adoption is not expected to have a material impact on our consolidated financial position, results of operations or cash flows.

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BUSINESS

Overview

We are a rapidly growing provider of three- and five-gallon purified bottled water and water dispensers sold through major retailers nationwide. We believe the market for purified water is growing due to evolving taste preferences, perceived health benefits and concerns regarding the quality of municipal tap water. Our products provide an environmentally friendly, economical, convenient and healthy solution for consuming purified water. Our business is designed to generate recurring demand for Primo purified bottled water through the initial sale of our innovative water dispensers. This business strategy is commonly referred to as razor-razorblade because the initial sale of a product creates a base of users who frequently purchase complementary consumable products. Once our bottled water is consumed using a water dispenser, empty bottles are exchanged at our recycling center displays where consumers receive a recycling ticket that offers a discount toward the purchase of a full bottle of Primo purified water. We believe Primo consumers purchase an average of 35 bottles of water annually and each bottle can be sanitized and reused up to 40 times before being taken out of use, crushed and recycled, substantially reducing landfill waste compared to consumption of an equivalent volume of single-serve bottled water. As of December 31, 2009, our water bottle exchange service and water dispensers were offered in each of the contiguous United States and located in approximately 7,000 and 5,500 retail locations respectively, including Lowe s Home Improvement, Sam s Club, Costco, Walmart, Target, Kroger, Winn-Dixie, Albertsons and Walgreens.

We have created a new nationwide single-vendor water bottle exchange solution for our retail customers, addressing a market demand that we believe was previously unmet. Our water bottle exchange solution is easy for retailers to implement, requires minimal management supervision and store-based labor and provides centralized billing and detailed performance reports. Our solution offers retailers attractive financial margins and the ability to optimize typically unused retail space with our displays. Additionally, due to the recurring nature of water consumption and water bottle exchange, retailers benefit from year-round customer traffic and highly predictable revenue.

We deliver our solution to retailers utilizing our national network. Our independent bottlers and distributors typically have made already the capital investment required to deliver our solution, including investment in bottling facilities and storage and distribution assets. We focus our capital expenditures on developing new retail relationships, installing displays at store locations, raising brand awareness, research and development for new products and maintaining our MIS tools. We are able to manage our national network on a real-time basis through

our MIS tools, which provide resource planning and delivery schedule tracking, thus enabling us to optimize our network s assets and respond to customer needs. In addition, our national network benefits from the recurring nature of water consumption and water bottle exchange that generates year-round demand and optimizes utilization of their existing production and distribution assets. In addition, our national network benefits from our MIS tools that assist resource planning and delivery schedule optimization. We believe our solution and national network provide us a significant competitive advantage in servicing our retail customers.

We benefit significantly from management experience gained over the last 15 years in exchange-based businesses, which enables us to implement best practices and develop and maintain key business relationships. Prior to founding Primo, our Chief Executive Officer founded Blue Rhino Corporation, a propane cylinder exchange business, in 1994 and, with several of our other key executive officers, led its initial public offering in 1998 and successful sale in 2004. At the time of the sale, we believe Blue Rhino was a market leader in propane grill cylinder exchange with over 29,000 retail locations in 49 states.

Industry Background

We believe there are several trends that support consumer demand for our water bottle exchange service, water dispensers and, following the Culligan Refill Acquisition, refill vending services, including the following:

Emphasis on Health and Wellness

The majority of the human body is comprised of water and nearly all critical body functions rely on proper hydration. As part of a desire to live a healthier lifestyle, we believe consumers are increasingly focused on drinking more water relative to consumption of high caloric beverages, carbonated soft drinks and beverages containing artificial sweeteners.

Concerns Regarding Quality of Municipal Tap Water

Many consumers purchase purified water not only due to better taste, but also because of concerns regarding municipal tap water quality. Municipal water is typically surface water that is treated centrally and pumped to homes, which can allow additional contaminants to dissolve into the water through municipal or household pipes impacting taste and quality. There have been many recent publications highlighting pollution and quality issues with municipal water in the United States. Additionally, due to budgetary deficits, municipalities are increasingly privatizing their water treatment and distribution systems, and there have been many compliance and quality issues documented in connection with privatized municipal water systems.

Growing Preference for Purified Water

We believe consumer preference toward purified water relative to tap water continues to grow. With increasing availability in recent years, purified water has become accepted on a mainstream basis and preferred by many over municipal tap water. While it is difficult to quantify purified water consumption in all of its forms, we believe the growth of bottled water consumption reflects this trend. According to a June 2009 report by independent market analyst Datamonitor, *Bottled Water in the United States*, consumers spent $18.4 billion in 2008 on bottled water and the industry is expected to grow at a compound annual growth rate of approximately 7.5%, reaching $26.5 billion by 2013.

Increasing Demand for Products with Lower Environmental Impact

We believe that consumers are increasingly favoring products with a lower environmental impact with a reuse, recycle, reduce mindset becoming a common driver of consumer behavior. Areas of concern include products packaging materials, carbon footprint and crude oil usage in production and distribution and the impact on landfills when disposed. Most single-serve PET water bottles are produced using fossil fuels and contribute to landfill waste given that only 27% of PET bottles are recycled according to a November 2009 Environmental

Protection Agency report. Additionally, according to the December 2008 report, *Bottled Water-U.S.,* by Mintel International Group Limited, the incidence of people who do not drink single-serve PET bottled water because of environmental concerns nearly doubled from 18.0% in 2007 to 35.0% in 2008. Governmental legislation also reflects these concerns with the passage of bottle bills in many jurisdictions that tax the purchase of plastic water bottles, require deposits with the purchase of certain plastic bottles, prohibit the use of government funds to purchase plastic water bottles and ban certain plastic bottles from landfills.

Source: National Association for PET Container Resources 2005 and 2008 Reports on Postconsumer PET Container Recycling Activity.

Availability of an Economical Water Bottle Exchange Service and Innovative Water Dispensers

According to 2007 United States census data, there are approximately 112 million households. Based on estimates derived from industry data, we believe the current household penetration rate of multi-gallon water dispensers is approximately 4%, with the vast majority of these households utilizing traditional home delivery services. Until recently, there has been little innovation, design enhancement and functionality improvement in water dispensers to meet modern household needs and competing water dispensers have traditionally retailed at prices we believe are unlikely to support greater household adoption. Compounding these issues, there previously was no viable provider of an economical water bottle exchange service with major retailer relationships nationwide to promote dispenser usage beyond the traditional home delivery model. We believe our water bottle exchange service provides this alternative and we believe we are currently the only provider delivering a solution nationally to retailers. We believe there are over 200,000 major retail locations throughout the United States and Canada that we can target to sell our dispensers or offer our water bottle exchange service and, following the Culligan Refill Acquisition, refill vending services.

Our Competitive Strengths

We believe that our competitive strengths include the following:

Appeal to Consumer Preferences

Environmental Awareness. Our water bottle exchange service incorporates reuse of existing bottles, recycles water bottles when their lifecycle is complete and reduces landfill waste and fossil fuel usage compared to alternative methods of bottled water consumption. Our three- and five-gallon water bottles are exchanged, sanitized and reused up to 40 times before being taken out of service, crushed and recycled. Given its typical exchange lifecycle, one Primo five-gallon water bottle provides consumers with water in an amount equivalent to approximately 1,200 16 ounce single-serve PET bottles. When used as an alternative for consuming purified water, based on current recycling rates, one Primo five-gallon water bottle can prevent

approximately 875 16 ounce single-serve PET bottles from contributing to landfill waste. In addition, we believe our water bottle exchange service uses less fossil fuel in the distribution process and has a lower carbon footprint than alternative methods of bottled water consumption. Our geographically dispersed national network is typically closer to major retailers than our centralized single-serve bottled water competitors. In addition, our exchange service is utilized by consumers as part of their ordinary shopping patterns, compared to separate, non-optimized deliveries typically associated with traditional home delivery providers, generally by less fuel efficient vehicles.

Value. We provide consumers the opportunity for cost savings when consuming our bottled water compared to both single-serve bottled water and typical home and office delivery services. We believe our five-gallon bottles of purified water typically cost a consumer between $4.69 and $7.99, after giving effect to the discount provided by our recycling ticket. We believe this compares favorably to the cost of single-serve PET bottles, case pack water and most home and office delivery services. The cost savings provided by our recycle ticket also provides consumers an incentive to remain a user of our water bottle exchange service. Finally, our water dispensers are sold at attractive retail prices in order to enhance consumer awareness and adoption of our water bottle exchange service, increase household penetration and drive sales of our bottled water.

Convenience. Our water bottle exchange service and water dispensers are available at major retail locations nationwide. In addition, our water bottle exchange service provides consumers the convenience of exchanging empty bottles and purchasing full bottles at any participating retailer. We offer three- and five-gallon water bottle options to address different consumer volume preferences. We believe our water bottle exchange service provides a convenient way to consume purified water compared to home and office delivery services. Our water bottle sales displays are fully stocked and ready for consumer purchases. In addition, our exchange service permits consumers to purchase only the number of water bottles they need without the water bottle purchase minimums or bottle deposits often charged by home and office delivery providers.

Taste. We have dedicated significant time and effort in developing our water purification process and formulating the proprietary blend of mineral ingredients included in Primo purified water that we believe has a silky smooth taste. In an independent taste test that we commissioned and was conducted in six regions throughout the United States in 2007, four out of five participants on average preferred Primo purified water over municipal tap water and three out of four participants on average preferred Primo purified water over their region s market-leading bottled water.

Health and Wellness. As part of a desire to live a healthier lifestyle, we believe that consumers are increasingly focused on drinking more water relative to consumption of other beverages. As we raise our brand awareness, we believe consumers will recognize that our water bottle exchange service is an effective option for their purified water consumption needs.

Key Retail Relationships Served by Nationwide Single-Vendor Solution

We believe we are the only water bottle exchange provider with a single-vendor solution for retailers nationwide. Our solution is easy to implement and supervise for national and regionally concentrated major retailers. We manage our national network to service our retail customers. This network utilizes our MIS tools and processes to optimize their production and distribution assets while servicing our retail customers. We believe the combination of our major retail relationships, unique single-vendor solution for retail customers, national network and our MIS tools is difficult to replicate. We anticipate these factors will facilitate our introduction of new purified water-related products in the future.

Ability to Attract and Retain Consumers

We offer razor-razorblade products designed to generate recurring demand for Primo purified bottled water (the razorblade) through the initial sale of our innovative water dispensers (the razor), which include a coupon for a free three- or five-gallon Primo bottle of water. We acquire new consumers and enhance recycling efforts by accepting most dispenser-compatible water bottles in exchange for a recycle ticket discount toward the purchase of a full bottle of Primo purified water. Our water bottle exchange service is attractive to retailers as our consumers purchase what we believe to be an average of 35 bottles of Primo purified water per year, which facilitates repeat consumer traffic in our retailers stores. In addition, based on discussions with our retail customers, we believe we are a leading provider of water dispensers to U.S. retailers, a status we believe we achieved within less than two years of entering the market. We believe this rapid success is due to the innovative features, design elements and attractive retail prices of our water dispensers. We further believe our offering high-quality water dispensers enhances consumer awareness and adoption of our water bottle exchange service, increases household penetration and drives sales of our bottled water.

Efficient Business Model

Our business model allows us to efficiently offer our solution to our retail partners and centrally manage our national network without a substantial capital investment. We believe our business processes and MIS tools enable us to manage the bottling and distribution of our water, our product quality, retailer inventory levels and the return of used bottles on a centralized basis, leveraging our invested capital and personnel. We own the bottles, transportation racks, mineral injectors and sales and recycling displays to ensure product quality and proper positioning of the Primo brand. We focus our capital expenditures on developing new retail relationships, installing displays at store locations, raising brand awareness, research and development for new products and maintaining our MIS tools. We believe our water bottle exchange service is unique in that we are not required to make a significant portion of the capital investment required to operate our exchange service nationwide. Participation in our water bottle exchange service does not typically require independent bottlers and distributors to make substantial new investments because they often are able to augment their current production capacity and leverage their existing bottling and distribution assets. In addition, the flow of payments between the retailer and our bottlers and independent distributors is a critical component of our overall relationship with our major retail accounts that we control efficiently through electronic data interchange.

Benefit from Management s Proven Track Record

We benefit greatly from management experience gained over the last 15 years in exchange businesses, which enables us to implement and refine best practices and develop and maintain key business relationships. Our Chief Executive Officer, Billy D. Prim, founded Blue Rhino Corporation, a propane cylinder exchange business, in 1994 and led its IPO in 1998 and its successful sale in 2004. At the time of the sale, we believe Blue Rhino was a market leader of propane grill cylinder exchange with over 29,000 retail locations in 49 states. In addition to our Chief Executive Officer, our Chief Financial Officer, Senior Vice President of Operations, Vice President of Products and Vice President of National Accounts all held comparable positions within the Blue Rhino organization during its rapid sales and location growth. We believe this experience combined with our nationwide single-vendor solution contributed to Walmart s recent decision to name Primo category manager for water bottle exchange and water dispensers.

Growth Strategy

We seek to increase our market share and drive further growth in our business by pursuing the following strategies:

Increase Penetration with Existing Retail Relationships and Develop New Retail Relationships

We believe we have significant opportunities to increase store penetration with our existing retail relationships. As of December 31, 2009, our water bottle exchange service was offered at 6,000 of our top ten retailers

nationwide locations. Such retailers present us an opportunity of approximately 7,500 additional nationwide locations. As of December 31, 2009, the Culligan Refill Business was offered at approximately 3,400 of its top ten retailers locations. Such retailers present the Culligan Refill Business an opportunity of approximately 6,600 additional locations.

There is minimal overlap of fewer than 100 locations where our water bottle exchange service is offered and the Culligan Refill Business is operated. Following the Culligan Refill Acquisition, we intend to further penetrate our other existing retail customers with both our water bottle exchange service and the Culligan Refill Business which collectively provide us the opportunity to be present in more than 20,000 additional locations.

Our long-term strategy includes targeting more than 50,000 total retail store locations (which includes new locations with our existing retail customers) within our primary retail categories of home centers, hardware stores, mass merchants, membership warehouses, grocery stores, drug stores and discount general merchandise stores for our water bottle exchange service or the Culligan Refill Business. We believe that the introduction of additional hydration solutions to our product portfolio will allow us to cross-sell products to our existing and newly-acquired retail customers.

Within two years of Primo s inception, we expanded our retail presence from 13 states to our current locations within each of the contiguous United States. In addition, from 2005 through 2009, we increased our water bottle exchange locations from approximately 300 to 7,000, representing a compound annual growth rate of approximately 120%.

Drive Consumer Adoption Through Innovative Water Dispenser Models

We intend to continue to develop and sell innovative water dispensers at attractive retail prices, which we believe is critical to increasing consumer awareness and driving consumer adoption of our water bottle exchange service. We believe our water dispensers have appealing features, such as stainless steel finishes, adjustable hot and cold temperature controls and hidden bottle bottom-loading features for convenience. As a result of our strategy of developing innovative water dispensers, we believe based on discussions with our retail customers that we became a leading seller of water dispensers to retailers within less than two years of our entry into the market. Since we began selling our water dispensers in 2005, we have sold over 520,000 units, and have expanded our retail network from four locations as of December 31, 2007, to our current network of approximately 5,500 locations. We plan to continue introducing new dispenser models at attractive retail price points to meet the evolving needs of consumers, enhance consumer awareness and adoption of our water bottle exchange service, and increase household penetration. Our long term strategy is to provide multiple purified water-based beverages from a single Primo water dispenser, with consistent promotion of our water bottle exchange and, following the Culligan Refill Acquisition, refill vending services to supply the purified water.

Increase Same Store Sales

We offer razor-razorblade products designed to generate recurring demand for Primo purified bottled water and, upon the consummation of the Culligan Refill Acquisition, drinking water refill vending services (the razorblade) through the initial sale of water dispensers (the razor). We sell our water dispensers at minimal margin and provide a coupon for a free three- or five-gallon bottle of water with the sale of various water dispensers at certain retailers to drive consumer demand for our water bottle exchange and, following the Culligan Refill Acquisition, refill vending services.

We believe increasing unit sales of Primo purified bottled water is dependent on generating greater consumer awareness of the environmentally friendly and economical aspects of and the convenience associated with both our purified bottled water and our water bottle exchange and, following the Culligan Refill Acquisition, refill vending

services. We expect that our branding, marketing and sales efforts will result in greater usage of our water bottle exchange and, following the Culligan Refill Acquisition, refill vending services. We are also increasing our public relations initiatives associated with new market launches, developing additional cooperative advertising programs

with retail distribution partners and increasing our field marketing activities. In addition, as consumers exchange dispenser-compatible water bottles, we encourage the use of our water bottle exchange service by providing them a recycling ticket that provides a discount on a full bottle of Primo purified water.

Develop and Install Other Hydration Solutions

We believe we have significant opportunities to leverage our national network and our systems and processes to offer other environmentally friendly, economical, convenient and healthy hydration solutions to our retail partners without significant increases in our centralized costs. For example, the Culligan Refill Business will provide us an established platform to offer our retail partners self-service refill vending machines that dispense drinking water into empty reusable water bottles. We believe this offering will cater to a more price-sensitive consumer. In addition, we intend to offer to our retail partners automated, self-bagging purified ice dispensers. These purified ice dispensers will provide a simplified method of acquiring ice in customized offering sizes without the extensive manufacturing and storage networks typical of the ice dispensing industry.

Pursue Strategic Acquisitions to Augment Geographic and Retail Relationships

In addition to the Culligan Refill Acquisition, we believe opportunities exist to expand through selective acquisitions, including smaller water bottle exchange businesses with established retail accounts, other on-premises self-service water refill vending machine networks and retail accounts, ice dispenser machine networks and retail accounts and water dispenser companies.

Product Overview

Water

We have dedicated significant time and effort in developing our water purification process and formulating the proprietary blend of mineral ingredients included in our purified water. Our proprietary blend of mineral ingredients was developed with the assistance of consultants and several months of lab work and taste tests and has what we believe to be a silky smooth taste. In an independent taste test that we commissioned and was conducted in six regions throughout the United States in 2007, four out of five participants on average preferred Primo purified bottled water over tap water and three out of four participants on average preferred Primo over their region s market-leading bottled water brand. We believe it is important that each bottle of Primo purified water has consistent taste and each production lot is tested by the bottler to ensure it meets our standards. In addition, to ensure that our safety standards are met and FDA and industry standards are met or exceeded, each production lot of our purified water undergoes chemical and microbiological testing by the bottler and all facilities bottling Primo purified water undergo regular hygiene audits by a third party hired by us.

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Water Bottles

We currently source three- and five-gallon water bottles from multiple independent vendors for use in our exchange service. Each of our Primo water bottles includes a handle designed for easy transportation and lifting when installing the bottle onto or into one of our water dispensers. Our bottles also include a specially designed cap that prevents spills when carrying or installing.

Water Dispensers

We currently source and market three lines of water dispensers comprised of 15 models:

Our dispensers are designed to dispense Primo and other dispenser-compatible bottled water. Our dispensers have manufacturer suggested retail prices that range from $199.99 for our top-of-the-line bottom-loading model with a stainless steel finish to $14.99 for a simple pump that can be installed on a bottle and operated by hand.

Currently, more than 95% of our dispenser sales are attributable to our bottom- and top-loading products. Consistent with our environmental focus, our electric dispensers are Energy Star® rated, and, we believe, utilize less energy than competing water dispensers without this industry rating. In addition, some of our dispenser models

feature power switches to individually control the hot and cold tanks of the dispenser, saving additional energy when not in use and providing a child-safety feature. We believe both our bottom- and top-loading models dispense water twice as fast as competing products and have the fastest recovery time for heating and cooling water. In addition, certain models of our bottom-and top-loading dispensers come equipped with adjustable hot and cold temperature controls conveniently located on the top of the dispenser.

We believe our bottom loading dispensers are attractive to consumers and will drive the greatest increase in household penetration as a result of their innovative styling and features. Water bottles are loaded and concealed inside our bottom-loading dispensers by a hinged door for ease of use and a clean aesthetic appearance.

Currently, all of our water dispensers are manufactured by independent suppliers in China. Our dispensers are shipped directly to our retailer partners and we do not use distributors in connection with our water dispensers. We also provide private label water dispensers to Target that are branded as Black & Decker products pursuant to a license agreement with The Black & Decker Corporation.

Primo Water Marketing

Our marketing efforts focus primarily on developing and maintaining a brand identity synonymous with an environmentally friendly, economical, convenient and healthy solution for purified water consumption. We direct our marketing efforts as close as possible to the point of sale to strengthen our brand and promote consumer awareness of our water bottle exchange service. We believe our water bottle exchange service develops consumer loyalty through the use of our recycling tickets. Our marketing efforts include the following initiatives:

Primo Water Packaging

Our three- and five-gallon water bottles, sales and recycling center displays, water dispensers and certain distributor delivery vehicles prominently display our Primo logo and distinctive four-bubble design.

Primo Water Displays

Our sales and recycling center displays are typically located near the front of a store, providing point-of-sale advertising and branding. We believe our displays enhance consumer awareness of the Primo brand and reinforce the association of our water with an environmentally friendly, economical, convenient and healthy solution for purified water consumption. Our displays include Primo graphics, slogans and instructions on the exchange process that simply attach to the displays. We have the ability to quickly replace, customize or introduce new marketing materials on our displays throughout our retail network. In addition, we work with retailers to customize in-store solutions to best promote our brand.

Promotions

Our promotional activities target new customers by:

- Accepting third-party dispenser-compatible water bottles in the exchange process (which we believe is unique in the industry);
- Providing attractive pricing on our water dispensers;
- Offering a free bottle of water with the purchase of a water dispenser;

Advertising in retailers weekly circulars; and

Providing samples of our purified water and water dispensers on-site at our retailers locations and educating consumers on the benefits of our purified bottled water and dispensers.

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We promote our brand through social media, our website (*www.primowater.com*) and other public relations efforts. We also maintain a blog (*www.breakfree411.com*) that is styled as a third-party website and provides updates on the water industry. In addition, we seek to raise awareness of our brand and products through blogs and related periodicals that target women as well as household and kitchen matters. We believe that women often significantly influence household and kitchen appliance decisions and concentrating our efforts in this manner is designed to improve the effectiveness of our advertising campaigns and improve household penetration.

Our promotional activities have evolved from our Taste Perfection campaign to our Zero Waste. Perfect Taste, campaign emphasizing our environmental efforts while simultaneously focusing on the taste of our purified water. We plan to increase our promotional activity as we expand our business.

The Primo Water Bottle Exchange Supply Chain

Water Purification and Bottling

Our independent bottlers are responsible for the water purification and bottling process and use their own equipment to complete this process. Our bottling process begins with either spring water or water from a public source that is processed through a pre-filtration stage to remove large particles. The water is then passed through polishing filters to catch smaller particles followed by a carbon filtration process that removes odors, tastes, sanitization by-products and pharmaceutical chemicals. A microfiltration process then removes microbes before the water is passed through a softener to increase the purification efficiency. The water next passes through the last phase of reverse osmosis or distillation, completing the purification process. After the purification process is complete, our proprietary blend of mineral ingredients is injected into the water followed by the final ozonation process to sanitize the water. A bottle is filled with Primo purified water only after the inspection and sanitization steps outlined below are completed. Each of our production lots is placed on a 48-hour hold to allow for testing by the bottler and to ensure successful compliance with chemical and microbiological standards. We have the ability to trace each bottle of Primo water to its bottling and distributor sources, and we regularly perform recall tests to ensure our ability to react to a contamination event should it occur. In comparison, municipal water is generally treated at a centralized processing facility and then distributed throughout the pipeline network. As the water flows to the point of use, contaminants and other foreign objects may be dissolved into the water, and household piping and faucets may collect sediment that over time reduces the quality of municipally supplied water.

Our distributors are responsible for collecting empty Primo bottles and other dispenser-compatible bottles that are deposited into our recycling center displays. At the completion of the delivery cycle, a distributor inspects the exchanged bottles for reusability and coordinates the recycling efforts with our operations personnel to ensure that reuse of each water bottle we receive in the exchange process is being optimized. Our water bottles can be sanitized and reused up to 40 times before being taken out of use, crushed and recycled, substantially reducing landfill waste compared to consumption of similar amounts of single-serve PET bottled water. Bottles that pass a distributor s initial inspection are subject to three washing cycles to remove particles. Bottles are then passed through two sanitization stages before a final rinse with hyper-ozonated water to kill or inactivate any microbes that remain at that point in the sanitization process. The water bottles are then ready to be filled with our purified water.

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Distribution Network

We rely on our national network to deliver our solution to retailers. Our water bottle exchange process begins when a distributor is directed through our proprietary MIS tool, Routeview, to stock or replenish a Primo bottled water retail location. Routeview enables our distributors to review delivery quantities and tentative scheduling requirements in their territory. Our systems provide anticipated demand based on historical sales and, to the extent available, retailer point of sale (POS) data. Each distributor is provided information to enable the distributor to load a truck with the appropriate inventory to stock or restock the water bottle sales displays on its route, including a tailored amount of excess bottles as safety stock. Upon arrival at each retail location, the driver first visits the recycling center display to collect empty Primo and other dispenser-compatible bottles. The driver enters data related to empty bottles on a handheld device to collect exchange efficiency information and potential customer conversion data and then loads empty bottles onto the truck. The driver next checks the in-store sales display to compare the number of remaining bottles of water with the anticipated demand report generated by our MIS tools. After entering current stock levels, the driver is instructed by our MIS tools through the handheld device and based on proprietary algorithms, to replenish the sales display with an appropriate quantity of bottles.

At the completion of the delivery cycle and after inspection of the bottles, our distributors typically are responsible for coordinating the sanitization and bottling process with our bottlers. In addition, distributors must run end-of-day reports on their handheld devices which transmit crucial data points into our databases and validate

daily activity. Our handheld devices also capture electronic signatures, significantly reducing paper exchange. This greatly improves our verification procedures and enhances our environmental efforts.

*** Certain independent distributors operate multiple distribution sites and the Company-owned distribution sites in North Carolina and Virginia are part of a single Company-owned distribution operation.

We have the ability to test and refine procedures through our Company-operated distribution system before implementing them with our independent distributors nationwide. In addition, we regularly solicit feedback from our independent distributors to improve processes.

Flow of Payments and Capital Requirements

We control the flow of payments between our retail customers and our bottlers and distributors through electronic data interchange. Our distributors are responsible for handling distribution and servicing our sales and recycling center displays. Through our handheld devices, distributors report their deliveries which are received by our systems and verified by data integrity checks. Depending on the retailer, our distributors either present the store manager with an invoice for the bottles delivered or our systems electronically bill the retailer. We compensate our distributors with a fixed payment per delivered water bottle on the fifteenth day of the month following the delivery activity. Our fixed payment is a gross amount from which the distributor must typically pay the bottler. In order to maximize their returns and profitability, our distributors increasingly are becoming vertically integrated, using their capital to build bottling facilities. Due to the high degree of automation during our billing and inventory management procedures, we are able to leverage our centralized personnel and believe we will be able to significantly expand our business with minimal increases in variable cost.

We focus our capital expenditures on developing new retail relationships, installing displays at store locations, raising brand awareness, research and development for new products and maintaining our MIS tools. We are also

responsible for the centralized operations and personnel, sales and recycling displays, bottles, transportation racks, mineral packets and mineral injectors and handheld devices. Our national network typically has made the capital investment required to operate our exchange service nationwide, including a majority of the capital expenditures related to the bottling, sanitization and refill process and the distribution assets such as delivery trucks and warehouse storage. Participation in our water bottle exchange service does not typically require the independent bottlers and distributors to make substantial new investments because they often are able to augment their current production capacity and leverage their existing bottling and distribution assets. In addition, many of our major retail customers have invested their capital to expand store locations and generate customer traffic.

Flow of Payments and Capital Requirements

Retailer Relationships

We target major retailers with either a national footprint or a significant regional concentration. Our relationships are diversified among the following retail categories and major accounts:

Retail Category	**Major Accounts**
Home Centers / Hardware Stores	Lowe s Home Improvement, Ace Hardware, True Value
Mass Merchants	Walmart, Target, Kmart
Grocery Stores	Kroger, Winn-Dixie, Albertsons, Food Lion
Membership Warehouses	Sam s Club, Costco
Drug Stores	Walgreens, CVS

Retailer Opportunity

We offer retailers a single-vendor solution. Our water bottle exchange service provides retailers with a year-round consumer product and an opportunity to increase sales and profits with minimal labor and financial investment. Through our national network, we are able to service major retailers nationwide. Retailers benefit from our water bottle exchange service that offers high margin and generates productivity from often underutilized interior and exterior retail space. In addition, our water bottle exchange service has the potential to increase retailers sales of ancillary products through increased traffic from repeat water bottle exchange consumers, who we believe purchase an average of 35 water bottles annually.

Account Set-Up

We actively pursue headquarters-based retail relationships to better serve our retail partners and minimize layers of approval and decision-making with regard to the roll-out of our water bottle exchange service to multiple locations. Upon confirmation of new retail locations, we coordinate with the retailer and distributor to schedule openings in a timely manner. We actively assist retailers in developing site plans for the setup of our sales and

recycling center displays. While retailer setup preferences may vary, retailers often like to locate the recycling center display prominently on the exterior of their store to ease the transaction process, showcase their recycling and environmental efforts and conserve inside floor space while at the same time promoting the Primo brand.

Account Service

Our water bottle exchange service is a turn-key program for retailers in which we and our distributors actively service each retail account. After the retail location is established, our distributors complete on-site training and have an economic interest in supporting and growing the business relationship to increase product throughput. Distributors deliver three- and five-gallon Primo bottled water directly to retail locations and maintain the sales and recycling center displays.

Sales Support

While distributors service our retail accounts, the customer relationship is owned and maintained by our experienced retail sales organization, which allows us to develop strong brand affinity and maintain key headquarters-based relationships to secure and maintain our national retail network. Our retail relationships are divided into regions and managed by our sales personnel. In addition, we leverage our independent distributors who typically employ their own sales representatives. This combined team is responsible for selling and supporting our water bottle exchange service to targeted retailers.

Systems Support

We supply each major retail customer with a customized sales and business update on a monthly basis. The monthly update consists of a graphical dashboard highlighting sales trends and location-based information as well as qualitative commentary to assist store and headquarters personnel in their business decisions. We believe our reports help retail personnel monitor the success of our water bottle exchange service and highlight our analytical and customer support capabilities as a retail partner. In many cases, our retail customers do not have internal reporting capabilities to develop comparable analyses.

Customer Service

We maintain a single toll-free number for all distributors, retailers and customers to contact us directly with questions regarding our bottled water, water bottle exchange process and customer service inquires. In addition, we maintain a separate toll-free number for our water dispensers. We believe maintaining our own customer service numbers allows us to effectively monitor all aspects of our business and receive feedback on issues first-hand that we can direct to our distributors or dispenser suppliers.

Significant Customers

For the year ended December 31, 2009, Lowe s Home Improvement, Sam s Club and Walmart represented approximately 33%, 19% and 15% of our total sales, respectively.

National Bottler and Distributor Network

In an effort to build a market-leading single-vendor national water bottle exchange service, we have sought to attract experienced and well-capitalized independent bottlers and distributors to support our retail partners. As of December 31, 2009, we had 55 independent bottlers and 27 independent distributors as well as our two Company-owned distribution operations covering portions of four states.

Bottler and Distributor Opportunity

We provide independent bottlers and distributors with an attractive business opportunity, complementing many of their existing operations. We continually pursue new relationships and additional locations with existing retail partners to increase the production at each bottler s manufacturing facility and the retail customer density within each distributor s territory.

Bottler and Distributor Standards

We work very closely with our national network to ensure their production and storage standards meet or exceed the requirements of the United States Food and Drug Administration and other industry regulations. As we seek to promote our brand, we believe it is critical to provide bottled water that has consistent taste and is produced in a manner that exceeds current industry requirements. We regularly monitor, test and arrange for third-party hygiene audits of each bottling facility.

In addition, we regularly monitor our distributors performance to ensure a high level of account service. Distributors are generally required to develop an infrastructure sufficient to:

Complete customer installations within 30 days of the notification of a newly established account;

Monitor and maintain inventory levels with assigned retail accounts; and

Resolve water bottle stock-outs within 36 hours.

Bottler and Distributor Selection Process

We have selectively identified and pursued high quality independent bottlers and distributors that can support our major retailers nationwide. We screen all independent bottler and distributor candidates by reviewing credit reports, safety records and manufacturing compliance reports, and conducting management reference checks. As a result of this thorough selection process, we have established what we believe to be highly dependable relationships with our independent bottlers and distributors. We currently maintain three distributor or bottler relationships that have relatively high customer concentrations in the geographic areas they serve. None of these independent distributors or bottlers, however, had responsibility for more than 8.0% of the bottling or more than 12.6% of the distribution with respect to our water bottle exchange volume for the year ended December 31, 2009. We believe we have a positive relationship with each of these parties and our senior executives have maintained a business relationship with each such party since they were managing operations at Blue Rhino Corporation.

Bottler and Distributor Services

We currently employ raw material procurement and supply chain personnel who perform periodic inventory audits and month-end review procedures. In addition we have operations personnel who manage our independent bottler and distributor relationships, including training and monitoring personnel and activities. We also employ customer service personnel who handle bottler, distributor, retailer and end-user phone calls.

Company Owned Distribution Operations

We currently own and operate two distribution operations that have distribution responsibilities for certain regions that are relatively near our primary facilities. We distribute our bottled water to major retailers in portions of North Carolina, South Carolina, Florida and Virginia. We believe distributing our bottled water in these areas is an important

way for us to better understand the bottled water exchange process and provides us the necessary feedback to enhance our independent bottler and distributor relationships. In addition, distributing our bottled water in these areas should assist us in validating the economic arrangements we offer our bottlers and distributors and developing industry knowledge that we can deploy throughout our system. For the year ended December 31,

2009, our two Company-owned distribution operations accounted for approximately 23.5% of our water bottle exchange volume.

Independent Bottler and Distributor Agreements

We have entered into bottler and distributor agreements with each of our independent bottlers and distributors on substantially similar terms. While individual agreements contain variances and exceptions, the material terms of such agreements are described generally below. No individual bottler or distributor is material to our overall financial condition or results of operations.

Independent Bottler Agreement

In our independent bottler agreement, we appoint a bottler as a non-exclusive supplier of our purified drinking water. The bottler is restricted from competing with us during the term of the agreement and for a specified period after the term in a specified geography.

The bottler is required to bottle and deliver product in conformance with our specifications, including our proprietary mineral formula. The bottler must ensure that our bottled water products comply with applicable laws, rules and regulations (including those of the FDA), industry standards (including those of the International Bottled Water Association) and our quality requirements. The agreement also imposes requirements on the bottler with respect to the maintenance of its facilities and equipment that are intended to ensure the quality of our products.

We provide the necessary bottles, caps, labels, transportation racks, mineral injectors and formula minerals at no charge to the bottler to support the bottling and supply of our bottled water products. The bottler is required to maintain inventory levels necessary to satisfy our production requirements. Product may not be released for shipment until the bottler meets all applicable quality requirements.

Pricing is set forth in the agreement, and we have the right to modify pricing on thirty days notice to the bottler. The agreements generally have a three-year term, and if not otherwise terminated, automatically renew for successive one-year periods after the initial term. Either party may terminate the agreement in the event of an uncured material breach by the other party.

Independent Distributor Agreement

In our independent distributor agreement, we grant a distributor the right to serve as our exclusive delivery and service agent and representative with respect to our bottled water exchange service for a specified term in a specified geographic territory. The distributor is restricted from competing with us during the term of the agreement and for a specified period after the term in the specified geography. We have the right, at any time, to purchase a distributor s rights under the agreement, along with related distribution equipment, for an amount based on the distributor s revenues under the agreement for the prior twelve-month period and the fair market value of the equipment being purchased.

The distributor must perform its services under the agreement in conformance with our distributor manual and all applicable laws and regulations, including those of the FDA.

We compensate a distributor for its services while maintaining a direct relationship with and collecting payments from our retailer customers within the distributor s service territory. Pricing is set forth in the agreement, and we have the right to modify pricing and payment terms on thirty days notice to the distributor.

The agreements generally have a ten-year term, and if not otherwise terminated, automatically renew for successive one-year terms after the initial ten-year term. Either party may terminate the agreement for, among other reasons, an uncured material breach by the other party.

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Management Information Systems

We have made a substantial investment in MIS tools which enhance our ability to process orders, manage inventory and accounts receivable, maintain distributor and customer information, maintain cost-efficient operations and assist distributors in delivering products and services on a timely basis. Our technology utilizes highly integrated, scalable software applications that cost-effectively support our growing retail network. Our MIS tools also allow us to analyze historical trends and data to further enhance the execution, service and identification of new markets and marketing opportunities. The primary components of our systems include the following:

Sales and Marketing Support Systems

We operate a single customer relationship management database that integrates all financial and transaction-based data with respect to each retail account. Our MIS tools provide our account managers and customer service representatives access to crucial data to effectively manage each bottler, distributor and retail relationship.

Bottler and Distributor Level Technology

Our distribution process is highly automated and scalable. Our technology allows bottlers and distributors timely access to information for customer support needs and provides access to real-time data to enhance decisions. In addition, each distributor is electronically linked to our systems with our proprietary Routeview software. Routeview enables distributors to review delivery quantities and tentative scheduling requirements across our entire national network. In addition, our MIS tools allow drivers to update delivery, inventory and invoicing information through handheld devices. This technology provides retailers with accurate and timely inventory and invoices and assists each distributor in managing its responsibilities.

Financial Integration

We utilize Microsoft s Dynamics GP software as our core platform which interfaces with all of our systems. Each handheld device is based on Microsoft s operating system and ensures integration within our reporting and financial databases. All delivery transactions are validated and data is imported into our database tables and mapped to corresponding accounting ledgers.

Manufacturing and Sourcing

Our manufacturing strategy is to utilize independent manufacturers to produce empty water bottles, sales displays and recycle centers and water dispensers at a reasonable cost. We believe that using independent manufacturers has several advantages over our manufacturing these items directly, including (i) decreased capital investment in manufacturing plants and equipment and working capital, (ii) the ability to leverage independent manufacturers purchasing relationships for lower materials costs, (iii) minimal fixed costs of maintaining unused manufacturing capacity and (iv) the ability to utilize our suppliers broad technical and process expertise.

Currently, the majority of our water dispensers are assembled by a single independent manufacturer in China, which utilizes several sub-suppliers to provide components and subassemblies. We have the sole North American rights to develop products with this manufacturer and each dispenser unit is produced to our design specifications. Each unit is inspected and tested for quality by the manufacturer s personnel prior to shipment and any units returned by consumers or retailers are sent directly to the manufacturer for a credit, replacement or refund issued by the manufacturer. Our units generally are shipped directly from Hong Kong to the retailer. For the year ended December 31, 2009, this manufacturer produced water dispenser units that accounted for more than 95% of our water dispenser billings.

Our water bottles and caps are produced by multiple independent vendors throughout the United States. We select suppliers based on price, quality and geographic proximity to our bottlers. We only purchase water bottles with handles as a convenience feature for consumers.

Our sales displays and recycle centers are made to our design. We frequently request bids from multiple independent manufacturers to achieve optimal pricing.

Product Design and Development

A primary focus of our product research and development efforts is developing innovative water dispensers as part of our strategy to enhance consumer awareness and adoption of our water bottle exchange service, increase household penetration and drive sales of our bottled water. We continually work to improve water dispenser features, seek to lower manufacturing costs so that our innovative products are more affordable and introduce new models. Innovative improvements developed in cooperation with our manufacturing partners include bottom-loading dispensers, adjustable hot and cold temperature controls and faster water dispensing capabilities. Our water dispenser models are designed to appeal to consumers of diverse demographic audiences. We are currently working with our manufacturing partners to develop a new product line that includes self-bagging automated purified ice dispensers. We expect to introduce this new product line in 2010. We are also in the early development stage of creating a water dispenser product that provides consumers the ability to dispense multiple purified water-based beverages, including traditional hot drink products and flavored and carbonated beverages.

Competition

We participate in the highly competitive bottled water segment of the nonalcoholic beverage industry. While the industry is dominated by large and well-known international companies, numerous smaller firms are also seeking to establish market niches. We believe we have a unique business model in the bottled water market in the United States in that we not only offer three- and five-gallon bottled water on a nationwide basis but also provide consumers the ability to exchange their used containers as part of our water bottle exchange service. We believe that we are one of the first companies to provide a national water bottle exchange service at retail. While we are aware of a few direct competitors that operate similar networks, we believe they operate on a much smaller scale than we do and do not have equivalent MIS tools or bottler and distributor capabilities to effectively support major retailers nationwide. Competitive factors with respect to our business include pricing, taste, advertising, sales promotion programs, product innovation, efficient production and distribution techniques, introduction of new packaging, and brand and trademark development and protection.

Our primary competitors in our bottled water business include Nestlé, The Coca-Cola Company, PepsiCo, Dr Pepper Snapple Group and DS Waters of America. While none of these companies currently offers a nationwide water bottle exchange service at retail, Nestlé and DS Waters of America offer this service on a regional basis. However, many of these competitors are leading consumer products companies, have substantially greater financial and other resources than we do, have established a strong brand presence with consumers and have established relationships with retailers, manufacturers, bottlers and distributors necessary to start an exchange business at retail locations nationwide should they decide to do so. In addition to competition between firms within the bottled water industry, the industry itself faces significant competition from other non-alcoholic beverages, including carbonated and non-carbonated soft drinks and waters, juices, sport and energy drinks, coffees, teas and spring and tap water.

We also compete directly and indirectly in the water dispenser marketplace. This marketplace is diverse and faces competition from other methods of purified water consumption such as countertop filtration systems, faucet mounted filtration systems, in-line whole-house filtration systems, water filtration dispensing products such as pitchers and jugs, standard and advanced feature water coolers and refrigerator-dispensed filtered and unfiltered water.

Intellectual Property and Trademarks

We believe that our intellectual property provides a competitive advantage and we have invested substantial time, effort and capital in establishing and protecting our intellectual property rights. We have filed certain patent applications and trademark registration applications and intend to seek additional patents, to develop additional trademarks and seek federal registrations for such trademarks and to develop other intellectual property. We

consider our Primo name and related trademarks and our other intellectual property to be valuable to our business and the establishment of a national branded bottled water exchange service. We rely on a combination of patent, copyright, trademark and trade secret laws and other arrangements to protect our proprietary rights. We own ten United States federal trademark registrations, including registrations for our Primo® and Taste Perfection® trademarks, our Primo® logo and our distinctive four bubble design. U.S. federal trademark registrations generally have a perpetual duration if they are properly maintained and renewed. We also own a pending application to register our Zero Waste. Perfect Taste™ trademark in the United States and Canada for use in association with drinking water dispensers, bottled drinking water and a variety of other non-alcoholic beverages. In addition, the design of our recycling center displays is protected by four United States design patents and two Canadian industrial design registrations. The United States design patents expire between May 2021 and April 2022 and, assuming that certain required fees are paid, the Canadian industrial design registrations expire in May 2017. We own three pending utility patent applications in the United States for our bottled water distribution method and bottle return apparatus (or our recycling center displays). Additionally, we are party to a license agreement with The Black & Decker Corporation, which expires December 31, 2010, pursuant to which we provide private label water dispensers to Target that are branded as Black & Decker products.

In addition to patent protection, we also rely on trade secrets and other non-patented proprietary information relating to our product development, business processes and operating activities. We regard portions of our proprietary MIS tools, various algorithms used in our business and the composition of our mineral formula to be valuable trade secrets of the Company. We seek to protect this information through appropriate efforts to maintain its secrecy, including confidentiality agreements.

Governmental Regulation

The conduct of our businesses and the production, distribution, advertising, promotion, labeling, safety, transportation, sale and use of our products are subject to various laws and regulations administered by federal, state and local governmental agencies in the United States. It is our policy to abide by the laws and regulations that apply to us, and we require our bottling, manufacturing, and distributing partners to comply with all laws and regulations applicable to them.

We are required to comply with:

- federal laws, such as the Federal Food, Drug and Cosmetic Act, the Occupational Safety and Health Act and the Americans with Disabilities Act;
- customs and foreign trade laws and regulations;
- state consumer protection laws;
- federal, state and local environmental, health and safety laws;
- laws governing equal employment opportunity and workplace activities; and
- various other federal, state and local statutes and regulations.

We maintain environmental, health and safety policies and a quality, environmental, health and safety program designed to ensure compliance with applicable laws and regulations.

The United States Food and Drug Administration (the FDA) regulates bottled water as a food under the federal Food, Drug and Cosmetic Act. Our bottled water must meet FDA requirements of safety for human consumption, identity, quality and labeling. Further, the sale and marketing of our products is subject to FDA s advertising and promotion requirements and restrictions. In addition, FDA has established current good manufacturing practice regulations, which govern the facilities, methods, practices and controls used for the

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processing, bottling and distribution of bottled drinking water. We and our third-party supply, bottling and distribution partners are subject to these requirements. We also must comply with overlapping and sometimes inconsistent state regulations in various jurisdictions. As a result, we must expend resources to continuously monitor state legislative and regulatory activities for purposes of identifying and ensuring compliance with the laws and regulations that apply to our bottled water business in each state in which we operate. While we must meet the government-mandated standards, we believe that our self-imposed standards meet or exceed those set by federal, state and local regulations.

Additionally, the manufacture, sale and use of resins used to make water bottles is subject to regulation by the FDA. Those regulations are concerned with substances used in food packaging materials, not with specific finished food packaging products. We believe our beverage containers are in compliance with FDA regulations. Additionally, the use of polycarbonates in food containers used by children under three years of age is subject to certain state and local restrictions.

Measures have been enacted in various localities and states that require a deposit or tax to be charged for certain non-refillable beverage containers. The precise requirements imposed by these measures vary. Other deposit, recycling or product stewardship proposals have been introduced in various jurisdictions. We anticipate that similar legislation or regulations may be proposed in the future at the local, state and federal levels.

Legal Proceedings

From time to time, we are a party to various lawsuits, claims and other legal proceedings arising from our normal business activities. We have not had, and we do not believe that we have currently, any proceedings that, individually or in the aggregate, would be expected to have a material adverse effect on our business, results of operations or financial condition.

Facilities

Our corporate headquarters, including our principal administrative, marketing, sales, technical support and research and development facilities, are located in Winston-Salem, North Carolina where we lease approximately 14,200 square feet under an agreement that expires on May 31, 2011.

In addition we lease warehouse space in Winston-Salem and Wilmington, North Carolina; Lakeland, Florida; and Petersburg, Virginia to support our Company-owned operations in these regions. These facilities have lease expirations that vary from November 2010 to May 2012.

We believe that our current facilities are suitable and adequate to meet our current needs, and that suitable additional or substitute space will be available as needed to accommodate expansion of our operations.

Employees

As of May 1, 2010, we had 77 employees. We believe that our continued success will depend on our ability to continue to attract and retain skilled personnel. We have never had a work stoppage and none of our employees are represented by a labor union. We believe our relationship with our employees is good.

CULLIGAN REFILL ACQUISITION

General

Simultaneously with the closing of this offering, we will acquire certain assets (the Culligan Refill Business) of Culligan Store Solutions, LLC and Culligan of Canada, Ltd. (together with Culligan International Company, Culligan) related to its business of providing reverse osmosis water filtration systems that generate filtered water for refill vending machines and store-use water services in the United States and Canada at approximately 4,500 retail locations. This business also sells empty reusable water bottles for use at refill vending machines (such businesses are together referred to as the Culligan Refill Business). We will fund the $105.0 million purchase price for the Culligan Refill Acquisition with a portion of the proceeds from this offering, with borrowings under our new senior revolving credit facility and through the issuance of our common stock. The acquisition of the Culligan Refill Business is referred to in this prospectus as the Culligan Refill Acquisition . The closing of this offering and the closing of the Culligan Refill Acquisition are interdependent as we will not consummate either unless we consummate both.

The Culligan Refill Business provides filtered water through the installation and servicing of reverse osmosis water filtration systems. Retailers benefit from the reverse osmosis water filtration systems as they ensure water used throughout a store is clean and safe for self-serve refill vending and store-use services, such as food preparation and hydration of produce. Customers of the Culligan Refill Business include Walmart, Safeway, Meijer, Sobeys, Target, Hy-Vee and Kroger. For the year ended December 31, 2009, the Culligan Refill Business generated revenues of $26.0 million and net income of $4.3 million. Approximately 84% of the Culligan Refill Business s revenues were generated in the United States, with operations in 48 states, and approximately 16% of its revenues were generated in Canada across 10 provinces. The Culligan Refill Business s revenues are driven by self-serve refill vending services and empty reusable water bottle sales, which account for approximately 76% and 16% of its revenues, respectively, and to a lesser extent by store-use services.

The Culligan Refill Business provides us with an established platform to expand into the self-serve water refill business. We believe the Culligan Refill Business is highly complementary to our water bottle exchange business from both a product and operational perspective. We believe the Culligan Refill Acquisition will:

- provide additional consumer value and convenience;
- augment our environmentally friendly product offering;
- allow us to leverage our marketing and increase the sales of our water dispensers;
- enhance our ability to provide retail customers a broad range of hydration solutions;
- deepen our retail customer relationships through a more extensive product offering;
- expand our retail customer base and geographic presence;
- strengthen our distribution network;
- increase our knowledge base of the refill segment and add experienced personnel; and
- provide a source of stable, dependable cash flows to fund future growth.

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The Culligan Refill Business

Overview

The principal product line of the Culligan Refill Business consists of a reverse osmosis water filtration system. This system filters water on site at retail locations and dispenses drinking water on a self service basis. As of March 31, 2010, the Culligan Refill Business had installed its reverse osmosis water filtration systems in approximately 4,500 retail customer locations in the United States and Canada.

Reverse Osmosis Water Filtration System

The reverse osmosis water filtration system that the Culligan Refill Business installs and maintains generally consists of a refill vending machine located within its customers retail space and reverse osmosis filtration equipment that is typically located in the back room of the retail customers store location. The refill vending machine is typically accompanied by a sales display containing empty reusable water bottles.

Refill Vending Machine and Empty Reusable Water Bottles

The use of reverse osmosis filtration equipment located in the back room benefits the retail customer in several ways, including:

- minimizing the refill vending machine s footprint within the customer s retail space;
- allowing the retail customer to use the filtered water for internal purposes such as in produce misters, ice makers and the customer s bakery;
- allowing preventative maintenance, repair and meter reading with minimal consumer interruption; and
- allowing filtration equipment modifications to increase water volume handling capacity without an increased footprint within the customer s retail space.

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Reverse Osmosis Water Filtration System

Retail customers also benefit from the filtration equipment as using filtered water for store-use purposes such as produce misters and ice makers extends the life of and reduces maintenance costs with respect to the retail customers in-store equipment.

The Culligan Refill Business also sells to retail customers a line of one-, three- and five-gallon empty reusable bottles to be sold to consumers for use at the refill vending machines.

During 2009, the Culligan Refill Business derived revenues from the following activities:

76% of its revenues from the sale of filtered drinking water through refill vending machines;

16% of its revenues from the sale of empty reusable water bottles; and

8% of its revenues from the store-use by its retail customers of the reverse osmosis water filtration system for produce misters, ice makers, the customer s bakery and other similar uses.

Marketing

Sales and marketing to retail customers of the Culligan Refill Business is accomplished primarily through direct selling activities. Sales managers and field sales personnel call directly on major retail accounts. Sales to consumers are accomplished principally through point of sale displays and literature at the site of each refill vending machine. The Culligan Refill Business also uses traditional merchandising techniques such as free samples, coupons, special pricing and other in-store promotional techniques to promote consumption of drinking water by the ultimate consumer.

We are required to rebrand the Culligan Refill Business within 12 months after the closing of the Culligan Refill Acquisition.

Product Distribution

The reverse osmosis water filtration systems used in the Culligan Refill Business are placed under services agreements with retail customers who pay fees based on the number of gallons of water used or dispensed by the system. Under this program, the Culligan Refill Business owns the water filtration system and contracts for the provision of all required service and maintenance. Water meters are generally read monthly by a third-party representative and an invoice is subsequently delivered to the retailer.

The revenue realized by the Culligan Refill Business on each reverse osmosis water filtration system is highly dependent upon the overall volume of water sold through a particular location. The consumer typically pays a price to the retailer for water from the refill vending machine ranging from approximately $0.25 to $0.50 per gallon, depending upon the location and the retailer s overall pricing strategy. The competitive nature of product pricing varies by geographic location.

Certain retail customers also use the reverse osmosis water filtration system for produce misters, ice makers, the customer s bakery and other similar uses. These retail customers are billed monthly for this store water usage with the charges based on each particular store s volume of water used.

Customers

A significant portion of the revenues of the Culligan Refill Business comes from a small group of major retail customers. For the year ended December 31, 2009, Walmart accounted for 65% of the net sales of the Culligan Refill Business, and no other retail customer accounted for more than 10% of its net sales. As of March 31, 2010, the Culligan Refill Business had installed its reverse osmosis water filtration systems in approximately 4,500 retail customer locations in 48 U.S. states (a total of approximately 3,800 locations) and 10 Canadian provinces (a total of approximately 700 locations). The Culligan Refill Business has long-standing relationships with most of its major retail customers. For example, its business relationship with Walmart began in 1991 and its business relationships with its next four largest retail customers began in 2005, 1995, 2000 and 1998, respectively.

Operational Process

The Culligan Refill Business has divided its operating territory into seven distinct geographic regions. The Culligan Refill Business has a district vending manager for each region who is responsible for managing the operations within the region as well as the oversight, support and management of the service providers servicing the retail locations within the region.

Sales Process

The Culligan Refill Business employs a direct sales force that actively pursues headquarters-based retail relationships to better serve the retailer customers and to minimize layers of approval and decision-making with regard to the addition of new retail locations. Upon confirmation of a new retail location, the Culligan Refill Business coordinates with the retailer and the service provider to schedule an installation in a timely manner.

The reverse osmosis water filtration system is part of a turn-key program for retailers in which the network of service providers actively service each retail account. After the water filtration equipment is installed and operational, the service provider completes on-site training with the retailer and has an ongoing economic interest in supporting and growing the business relationship to increase gallon sell through as the service providers are paid by the Culligan Refill Business based upon a percentage of water volume sales, subject to minimum and maximum commission amounts.

Retail Relationships

While individual retail locations are typically serviced by third party service providers, the customer relationship is owned and maintained by the experienced retail sales and service organization at the Culligan Refill Business, which allows a strong customer affinity and the maintenance of key headquarters-based relationships. The sales team routinely reviews sales results and trends with retail customers to provide suggestions for improving the sell through.

The retail relationships are divided into regions and managed by sales and service personnel.

Service Providers

The Culligan Refill Business has over 500 service providers who are responsible for the initial installation of the reverse osmosis water filtration systems, the regular maintenance of the systems, any necessary

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repairs, routine water testing and monthly meter reading to determine retail customer water usage. These service providers are comprised of Culligan International franchised dealers, service providers owned by subsidiaries of Culligan International and third-party service providers, which are responsible for serving retail store locations representing 56%, 25% and 19% of the revenues of the Culligan Refill Business for the year ended December 31, 2009, respectively. Typically, a service provider is paid a commission based on a percentage of the total revenues at the locations for which the service provider is responsible, subject to minimum and maximum commission amounts. Service providers also earn an hourly rate for initial installations of the reverse osmosis water filtration systems.

The Culligan Refill Business employs a field service team which provides training and support to its service providers and retail customers.

Reverse Osmosis Water Filtration Systems

The reverse osmosis water filtration system is comprised of two components: reverse osmosis water filtration equipment and a refill vending machine. The water filtration equipment is typically installed in the back room of a retail location and all such equipment generally has the same component filters and parts. A water line is installed from the water filtration equipment to the refill vending machine. The retail customer will specify the location of the refill vending machine, which is typically in the water aisle or back wall of the store. The retail customer is responsible for the plumbing, electrical and drainage requirements of an installation. An installation typically takes a few hours to complete, and the service provider that installed the system provides a completed work order to confirm the installation.

The Culligan Refill Business employs an operations team which assembles, refurbishes and repairs the refill vending machines. This team is located in its Eagan, Minnesota facility, where it routinely refurbishes equipment that has been in service for five years and longer or when a customer requests a refreshed system. The operations team also procures new filtration systems component parts and assembles the units and ships them to locations for installation by service providers. The component parts are generally sourced from multiple suppliers.

Maintenance

The regular maintenance completed by the service providers generally includes a monthly sanitization of the reverse osmosis water filtration system, a monthly system component check and any necessary preventative maintenance resulting from such component check and may include a water test for regulatory purposes. The various jurisdictions in which the Culligan Refill Business operates have specific bimonthly, monthly, quarterly or annual water testing reporting requirements with which it complies, but it performs water tests on each reverse osmosis water filtration system at least quarterly.

Customer Service

The Culligan Refill Business has a customer service team which coordinates service and bottle order replenishment requests from its retail customers. All calls are received and tracked through a toll-free telephone number for the United States and a separate telephone number for Canada. This team coordinates service requests to the service provider network and manages work orders to ensure completion of the service request. This team also addresses any consumer questions.

Administration

The accounting department of the Culligan Refill Business is responsible for billing and collecting from retail customers. Retailers are typically billed monthly based on a meter reading performed by the service provider that is

faxed to the billing department. The billing team enters the meter reading into a billing system and generates invoices for the retail customer, which are sent electronically or by mail to the retail customer. Retail customers generally have 30 day terms to pay invoices. The Culligan Refill Business utilizes an ERP system and document imaging system and has supplemented the system with its billing system.

Bottle Sourcing

The Culligan Refill Business sources empty reusable bottles from several manufacturing sources. The bottles are managed, inventoried and shipped through a 16,000 square foot leased warehouse facility in Oklahoma City, Oklahoma. The Culligan Refill Business co-owns with the bottle manufacturers certain bottle molds for bottles exclusively purchased for retailers.

The Culligan Refill Business has historically used a variety of suppliers and does not believe it is materially dependent on any single supplier. Alternate sources of supply are available for all of the critical components used in the Culligan Refill Business.

Services Agreements

The Culligan Refill Business has historically entered into services arrangements with its retail customers pursuant to which the Culligan Refill Business agrees to install and maintain its reverse osmosis water filtration system within the retail customer s store in exchange for typically monthly payments from the retail customer based on the store s water volume usage. These arrangements generally have terms of one to five years and the original terms of many of the agreements have expired. In such cases the arrangements have generally been automatically renewed or continue to operate on the same terms.

Competition

The Culligan Refill Business participates in the highly competitive bottled water segment of the nonalcoholic beverage industry. While the industry is dominated by large and well-known international companies, numerous smaller firms are also seeking to establish market niches. The business model of the Culligan Refill Business is differentiated from most of the participants in the North American nonalcoholic beverage industry in that it offers self-service refill of drinking water. There are a few direct competitors that offer similar refill vending services, but with the exception of Glacier Water Services, Inc., we believe these direct competitors generally operate on a smaller geographical and operational scale than the Culligan Refill Business. The Culligan Refill Business faces two levels of competition: (i) competition at the retail customer level to secure placement of its reverse osmosis water filtration systems in the store; and (ii) competition at an end-user level to convince consumers to purchase its water versus other options. Competitive factors with respect to the Culligan Refill Business include pricing, taste, advertising, sales promotion programs, retail placement, introduction of new packaging and branding.

Many of the indirect competitors in the bottled water segment of the nonalcoholic beverage industry are leading consumer products companies, have substantially greater financial and other resources than the Culligan Refill Business or us, have established a strong brand presence with consumers and have established relationships with retailers, manufacturers, bottlers and distributors necessary to start a self-service drinking water refill business at North American retail locations should they decide to do so. In addition to competition between firms within the bottled water industry, the industry itself faces significant competition from other nonalcoholic beverages, including carbonated and non-carbonated soft drinks and waters, juices, sport and energy drinks, coffees, teas and spring and tap water.

Intellectual Property and Trademarks

There are no material registered patents, trademarks or copyrights related to the Culligan Refill Business that we are acquiring in connection with the Culligan Refill Acquisition. However, employees of the Culligan Refill Business that will be joining our Company do possess important know-how related to the self-service drinking water refill business

and the reverse osmosis water filtration systems offered by the Culligan Refill Business. We consider this know-how to be an important part of the Culligan Refill Business and one of the principal reasons we believe the Culligan Refill Business will provide our Company a solid platform to include self-service drinking water refill in our product offerings.

Governmental Regulation

The conduct of the Culligan Refill Business and the production, distribution, advertising, promotion, labeling, safety, sale and use of its products are subject to various laws and regulations administered by federal, state, provincial and local governmental agencies in the United States and Canada. It is the policy of the Culligan Refill Business to abide by the laws and regulations that apply to it and the Culligan Refill Business requires manufacturing and service provider partners to comply with all laws and regulations applicable to them.

The refill vending machines used in the Culligan Refill Business are certified by the National Automatic Merchandising Association (NAMA). NAMA maintains a vending machine certification program which evaluates food and beverage vending machines against current requirements of the U.S. Public Health Service Ordinance and Code. The manufacturing facility used in connection with the Culligan Refill Business is required to be registered with the EPA under the provisions of the Federal Insecticide, Fungicide and Rodenticide Act because certain components used in connection with the reverse osmosis water filtration systems are deemed to be pesticidal devices. The Eagan, Minnesota facility has been registered as required.

Certain states have permit requirements for the operation of the refill vending machines. The Culligan Refill Business uses outside laboratories to periodically test the quality of the water dispensed through the refill vending machine. The water dispensed through the refill vending machine is also regularly tested by outside laboratories for the presence of coliform bacteria.

Legal Proceedings

From time to time, the Culligan Refill Business has been involved in various lawsuits, claims and other legal proceedings arising from its normal business activities. The Culligan Refill Business is not currently the subject of any proceedings that, individually or in the aggregate, would be expected to have a material adverse effect on its business, results of operations or financial condition.

Facilities

The Culligan Refill Business is headquartered in Eagan, Minnesota. We will assume the office lease relating to the headquarters facility for a term that expires in October 2014.

The Culligan Refill Business uses one warehouse and distribution facility located in Oklahoma City, Oklahoma. We will assume the lease related to this facility covering approximately 16,000 square feet for a term that expires in September 2010.

We believe that these facilities are suitable and adequate to meet our current needs with respect to the Culligan Refill Business, and that suitable additional or substitute space will be available to accommodate expansion of these operations.

Employees

As of March 31, 2010, the Culligan Refill Business had approximately 50 employees, none of which are represented by a labor union or covered by a collective bargaining agreement.

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MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OF THE CULLIGAN REFILL BUSINESS

The following discussion and analysis of the financial condition and results of operations of the Culligan Refill Business should be read in conjunction with the financial statements and related notes of the Culligan Refill Business appearing elsewhere in this prospectus. The actual results of the Culligan Refill Business could differ materially from those anticipated in the forward-looking statements included in this discussion as a result of certain factors, including, but not limited to, those discussed in the section of this prospectus titled Risk Factors.

Overview

The Culligan Refill Business provides reverse osmosis water filtration systems that generate filtered water for refill vending machines and store-use water services in the United States and Canada at approximately 4,500 retail locations. This business also sells empty reusable water bottles for use at refill vending machines. Retailers benefit from the Culligan Refill Business as it ensures water used throughout a store is clean and safe for self-serve refill vending and store-use services, such as food preparation and hydration of produce. Customers of the Culligan Refill Business include Walmart, Safeway, Meijer, Sobeys, Target, Hy-Vee and Kroger. For the year ended December 31, 2009, the Culligan Refill Business generated revenues of $26.0 million and net income of $4.3 million. Approximately 84% of the Culligan Refill Business s revenues were generated in the United States, with operations in 48 states, and approximately 16% of its revenues were generated in Canada across 10 provinces. The Culligan Refill Business s revenues are principally driven by self-serve refill vending services, empty reusable water bottle sales and store-use services, which account for approximately 76%, 16% and 8% of revenues, respectively.

Results of Operations

The following table sets forth the results of operations of the Culligan Refill Business for the periods indicated:

	Years Ended December 31,		Three Months Ended March 31,	
	2008	2009	2009	2010
	(in thousands)			
			(Unaudited)	
Consolidated statements of operations data:				
Net sales	$ 25,746	$ 26,017	$ 6,193	$ 6,109
Operating costs and expenses				
Cost of sales	13,635	13,643	3,324	3,247
Selling, general and administrative expenses	3,270	2,877	688	648
Depreciation and amortization	3,872	2,488	592	681
Total operating costs and expenses	20,777	19,008	4,604	4,576
Income from operations	4,969	7,009	1,589	1,533
Provision for income taxes	1,837	2,665	606	587
Net income	$ 3,132	$ 4,344	$ 983	$ 946

The following table sets forth the results of operations for the Culligan Refill Business expressed as a percentage of net sales for the periods indicated:

	Years Ended December 31,		Three Months Ended March 31, (Unaudited)	
	2008	2009	2009	2010
Consolidated statements of operations data:				
Net sales	100%	100%	100%	100%
Operating costs and expenses				
Cost of sales	53.0%	52.4%	53.7%	53.2%
Selling, general and administrative expenses	12.7%	11.1%	11.0%	10.6%
Depreciation and amortization	15.0%	9.6%	9.6%	11.1%
Total operating costs and expenses	80.7%	73.1%	74.3%	74.9%
Income from operations	19.3%	26.9%	25.7%	25.1%
Provision for income taxes	7.1%	10.2%	9.8%	9.6%
Net income	12.2%	16.7%	15.9%	15.5%

Three Months Ended March 31, 2010 Compared to Three Months Ended March 31, 2009

Net Sales. Net sales for the first quarter of 2010 decreased slightly by $0.1 million or 1.6% to $6.1 million from $6.2 million in the first quarter of 2009. The decrease in sales resulted primarily from lower volume in the U.S. in the vended water business. The first quarter is generally the weakest quarter of the year.

Gross Margin. Overall gross margin, defined as net sales less cost of sales, as a percentage of net sales increased to 46.8% for the first quarter of 2010 from 46.3% for the first quarter of 2009. The primary reason for the favorable change in margin was lower indirect labor costs.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the first quarter 2010 and 2009 were $0.6 million and $0.7 million, respectively, and as a percentage of net sales, decreased to 10.6% for the first quarter of 2010 from 11.0% for the first quarter of 2009. Selling, general and administrative expenses decreased as a result of lower outside service fees and office expenses.

Depreciation and Amortization. Depreciation and amortization increased 15.0% to $0.7 million in the first quarter of 2010 from $0.6 million in the first quarter of 2009. The increase in depreciation and amortization is primarily due to an increase in capital expenditures over the last twelve months.

Year Ended December 31, 2009 Compared to Year Ended December 31, 2008

Net Sales. Net sales for 2009 increased $0.3 million or 1.2% to $26.0 million from $25.7 million in 2008. The increase in sales resulted from a price increase as well as slightly higher volumes.

Gross Margin. Our overall gross margin, defined as net sales less cost of sales, as a percentage of net sales increased to 47.6% for 2009 from 47.0% for 2008. The primary reasons for the favorable change in margin were benefits from a price increase and slightly lower expenses.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for 2009 decreased $0.4 million or 12.1% to $2.9 million from $3.3 million and, as a percentage of net sales, decreased to 11.1% for 2009 from 12.7% for 2008. Selling, general and administrative expenses decreased as a result of lower bad debt and salary related expenses.

Depreciation and Amortization. Depreciation and amortization decreased by $1.4 million or 35.9% to $2.5 million in 2009 from $3.9 million in 2008. The decrease in depreciation and amortization expense is due to a significant amount of assets becoming fully depreciated in 2008.

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Critical Accounting Policies and Estimates

Revenue Recognition. Vended water dispensing machines placed at the retailers are used by consumers on a self-serve basis. Revenue is recognized at the time the meters are read during the servicing of the vended water dispensing machines. At December 31, 2009, there were approximately 4,500 refill vending machines, making the servicing of each machine at the end of each reporting period impractical. Consequently, the Culligan Refill Business estimates the revenue from the last time each machine was serviced until the end of the reporting period, based on the most current average daily volume of each machine. For the years ended December 31, 2009 and 2008, the Culligan Refill Business recorded approximately $1,051 and $1,050, respectively, of such revenues, which for both year-ends represent an average of approximately 22 days of use per machine.

The Culligan Refill Business recognizes revenue when empty bottles are shipped and the customer takes ownership and assumes risk of loss, collection of the relevant receivable is probable, persuasive evidence of an arrangement exists and the sales price is fixed or determinable. Shipping and other transportation costs charged to buyers are recorded in cost of sales.

Foreign Currency Translation. The Culligan Refill Business s operations are in the U.S. and Canada. Assets and liabilities denominated in Canadian dollars are translated into U.S. dollars at the current rate of exchange existing at period-end. Revenues, expenses, gains, and losses are translated at average monthly exchange rates. Translation adjustments are included in the combined statements of parent equity and comprehensive income for the Culligan Refill Business.

Goodwill and Other Intangible Assets. Goodwill reflected in the Culligan Refill Business s financial statements represents an allocation of the goodwill, the excess of costs over fair value of assets of business acquired, recorded by Culligan Holding S.àr.l at the date of acquisition of the Culligan Refill Business. The relative fair value approach was used as the basis for the allocation. The Culligan Refill Business is a component of the Culligan Holding S.àr.l reporting unit. Goodwill is not amortized but is instead tested at the reporting unit level for impairment at the reporting unit level at least annually in accordance with Accounting Standards Codification (ASC) Topic 350, *Intangibles- Goodwill and Other* (ASC 350). Culligan Holding S.àr.l completed its annual goodwill impairment tests as of December 31, 2009 and 2008 and determined that goodwill was not impaired during these years.

Impairment of Long-Lived Assets. The Culligan Refill Business reviews whether events or circumstances subsequent to the acquisition of any long-lived assets have occurred that indicate the remaining estimated useful lives of those assets may warrant revision or that the carrying value of those assets may not be recoverable. If events or circumstances indicate that the long-lived assets should be reviewed for possible impairment, the Culligan Refill Business uses projections to assess whether future cash flows on a nondiscounted basis related to the tested assets are likely to exceed the recorded carrying amount of those assets, to determine whether a write-down is appropriate. Should an impairment be identified, a loss would be recorded to the extent that the carrying value of the impaired assets exceeds their fair value as determined by valuation techniques appropriate in the circumstance, which could include the use of similar projections on a discounted basis. No such events or circumstances were identified during the years ended December 31, 2009 and 2008.

Fair Value of Financial Instruments. Financial instruments consist primarily of accounts receivable, accounts payable, and accrued liabilities. The carrying amounts of such instruments are considered to be representative of their respective fair values due to the short-term maturity of the instruments.

Concentrations of Risk. The Culligan Refill Business offers products and services to a fairly diverse customer base; however, one customer accounted for approximately 65% and 63% of the Culligan Refill Business s revenues in 2009

and 2008 and approximately 57% and 59% of accounts receivable as of December 31, 2009 and 2008, respectively. There is no significant supplier, product line, credit, geographic, or other concentrations that could expose the Culligan Refill Business to adverse near term severe financial impacts.

Culligan Refill Acquisition Agreements

Asset Purchase Agreement

On June 1, 2010, we entered into an asset purchase agreement with Culligan to purchase the assets related to the Culligan Refill Business for a total purchase price of $105.0 million consisting of:

- a cash payment of $60.0 million; and
- the issuance of shares of our common stock with a value of $45.0 million based upon the price that we issue shares in this offering (or shares, assuming an initial public offering price of $ per share, the midpoint of the range set forth on the cover page of this prospectus).

The purchase price for the Culligan Refill Business is subject to a working capital adjustment that is to be finally determined after the closing of the transaction. The cash portion of the purchase price will be increased and the number of shares of common stock we will issue will be decreased by an amount equal to the net cash proceeds we receive from any exercise of the underwriters over-allotment option. We will also assume certain specifically identified liabilities in connection with the Culligan Refill Acquisition.

The asset purchase agreement contains customary representations, warranties, covenants and conditions to closing.

In connection with the closing of the Culligan Refill Acquisition, we have entered or will enter into a trademark license agreement, two transition services agreements, a dealer services agreement, a non-compete agreement, a supply agreement, a lock-up agreement, a registration rights agreement and employment agreements with Jeanne Cantu, Vice President and General Manager of the Culligan Refill Business, and Carl Werner, Controller of the Culligan Refill Business.

Trademark License Agreement

At the closing of the Culligan Refill Acquisition, we will enter into a trademark license agreement with Culligan International Company, pursuant to which Culligan International Company will grant us a non-exclusive, royalty-free right and license to use certain of Culligan s trademarks in connection with the Culligan Refill Business within the United States and Canada. The term of the trademark license agreement is one year, unless sooner terminated in accordance with its provisions.

Transition Services Agreement

United States Transition Services Agreement

At the closing of the Culligan Refill Acquisition, we will enter into a transition services agreement with Culligan International Company, pursuant to which Culligan International Company will provide or cause to be provided certain services, including payroll and information technology services at no charge. We will use our commercially reasonable efforts to end our use of the provided services as soon as reasonably possible. Culligan International Company will provide such support as we may reasonably request to assist us in obtaining replacement services and exiting from the systems of Culligan International Company on or before the termination of the transition services agreement. This transition services agreement has a 60-day term, which commences on the date of the closing of the Culligan Refill Acquisition.

Canada Transition Services Agreement

At the closing of the Culligan Refill Acquisition, we will enter into a transition services agreement with Culligan of Canada, Ltd., pursuant to which Culligan of Canada, Ltd. will provide or cause to be provided certain services, including information technology, accounting and billing services at a rate of CAD$28,250 per

month. This transition services agreement will terminate on December 31, 2011 unless earlier terminated in accordance with its terms.

Dealer Services Agreement

At the closing of the Culligan Refill Acquisition, we will enter into a dealer services agreement with Culligan International Company, pursuant to which Culligan International Company will provide us with access to the Culligan-owned service providers and its franchisee service providers and will cause, or use commercially reasonable efforts to cause, such service providers to conduct the services they currently conduct with respect to the refill vending machines. The dealer services agreement will terminate on December 31, 2011 unless earlier terminated in accordance with its terms.

Non-Compete Agreement

At the closing of the Culligan Refill Acquisition, we will enter into a non-competition agreement with Culligan Store Solutions, LLC, Culligan of Canada, Ltd., and Culligan International Company, pursuant to which the Culligan entities will agree, subject to certain exceptions, to refrain from engaging in certain conduct for a period of five years, including:

- selling or providing certain products and services related to refill vending machines within a specified territory;
- soliciting or accepting as a customer any customer of the Culligan Refill Business for purposes of marketing, selling or providing certain products and services to such customer;
- soliciting or hiring certain current employees of the Culligan Refill Business; or
- providing certain products and services to any person for use by any person to engage in business similar to that of the Culligan Refill Business within a specified territory.

Supply Agreement

At the closing of the Culligan Refill Acquisition, we will enter into a supply agreement with Culligan International Company pursuant to which it has agreed to sell us certain water filtration equipment and products. This supply agreement has a one-year term, but will automatically renew for one-month periods unless either party provides notice of termination at least 30 days prior to the expiration of the then current term.

Lock-Up Agreement

Culligan Store Solutions, LLC and Culligan International Company have entered into a lock-up agreement pursuant to which they have agreed, subject to certain exceptions, not to offer, sell, contract to sell, pledge, grant any option to purchase, make any short sale or otherwise dispose of any shares of common stock, or any securities convertible into, exchangeable for or that represent the right to receive shares of common stock for a period of 180 days from the date of this prospectus without the prior written consent of Thomas Weisel Partners LLC and Wells Fargo Securities, LLC. There are no contractually specified conditions for the waiver of lock-up restrictions and any waiver is at the sole discretion of Thomas Weisel Partners LLC and Wells Fargo Securities, LLC, which may be granted by Thomas Weisel Partners LLC and Wells Fargo Securities, LLC for any reason. The 180-day lock-up period will be automatically extended if (i) during the last 17 days of the 180-day restricted period we issue an earnings release or announce material news or a material event or (ii) prior to the expiration of the 180-day restricted period, we announce that we will release earnings results during the 15-day period following the last day of the 180-day period, in which

case the restrictions described in this paragraph will continue to apply until the expiration of the 18-day period beginning on the issuance of the earnings release or the announcement of the material news or material event. After the lock-up period, these shares may be sold, subject to compliance with applicable securities laws.

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Registration Rights Agreement

At the closing of the Culligan Refill Acquisition, we will enter into a registration rights agreement with Culligan International Company pursuant to which we will agree, subject to certain exceptions, to prepare and file a registration statement to register the shares of our common stock received by Culligan in connection with the Culligan Refill Acquistion within 181 days of the consummation of the transaction. If this registration statement is not declared effective within such 181-day period or, subject to certain limitations, Culligan is not permitted to make sales pursuant to such registration statement after it is declared effective, we will be required to pay Culligan a ticking fee for any such period during which the registration statement is not effective or sales cannot be made. Such ticking fee will generally be calculated by multiplying Culligan s cost of capital at the relevant time (up to 12%) by the value of shares of our common stock then held by Culligan (calculated based upon the price we are selling shares in this offering).

Employment Agreements

Jeanne Cantu

We have entered into an employment agreement with Jeanne Cantu that is effective upon the closing of the Culligan Refill Acquisition pursuant to which Ms. Cantu has agreed to serve as a Vice President and General Manager of the Culligan Refill Business. Ms. Cantu will receive a base salary of $168,100, would receive severance in certain circumstances and would be subject to a one year non-competition covenant. This employment agreement has a term of two years.

Carl Werner

We have entered into an employment agreement with Carl Werner that is effective upon the closing of the Culligan Refill Acquisition pursuant to which Mr. Werner has agreed to serve as Controller of the Culligan Refill Business. Mr. Werner will receive a base salary of $91,637, would receive severance in certain circumstances and would be subject to a one year non-competition covenant. This employment agreement has a term of two years.

MANAGEMENT

Set forth below are our executive officers and directors, together with their positions and ages as of May 1, 2010.

Name	Age	Position
Billy D. Prim	54	Chairman, Chief Executive Officer, President and Director
Mark Castaneda	45	Chief Financial Officer
Michael S. Gunter	41	Senior Vice President, Operations
Duane G. Goodwin	51	Senior Vice President, Business Development
Richard A. Brenner	46	Director
David W. Dupree	55	Director
Malcolm McQuilkin	64	Director
David L. Warnock	51	Director

Set forth below is a brief description of the business experience of our directors and executive officers.

Billy D. Prim Chairman, Chief Executive Officer, President and Director. Mr. Prim has been our Chairman, Chief Executive Officer and President since he founded the Company in 2004. Mr. Prim has also served on our Board of Directors since 2004. Prior to founding the Company, Mr. Prim founded Blue Rhino Corporation (a provider of propane cylinder exchange and complementary propane and non-propane products) in March 1994 and served as its Chief Executive Officer and Chairman of the Board. He led Blue Rhino s initial public offering in May 1998 and remained its Chief Executive Officer until April 2004, when Blue Rhino was acquired by Ferrellgas Partners, L.P., at which time he was elected to the Ferrellgas board of directors on which he served until November 2008. Mr. Prim currently serves on the board of directors of Towne Park Ltd. and previously served on the board of directors of Southern Community Bank and Trust from 1996 until 2005. Mr. Prim brings extensive business, managerial and leadership experience to our Board of Directors. Mr. Prim s service as an executive and a Director of Primo provide our Board of Directors with a vital understanding and appreciation of our business. In addition, Mr. Prim s leadership abilities, his experience at Blue Rhino and his extensive knowledge of the bottled water industry position him well for service on our Board of Directors.

Mark Castaneda Chief Financial Officer. Mr. Castaneda has served as our Chief Financial Officer since March 2008. Prior to joining our Company, he served as Chief Financial Officer for Tecta America, Inc. (a private national roofing contractor) from October 2007 until March 2008, as Chief Financial Officer for Interact Public Safety (a private software company) from September 2006 until October 2007 and as Chief Financial Officer for Pike Electric Corporation (a publicly-traded energy solutions provider) from October 2004 until August 2006, where he helped lead its initial public offering in July 2005. Mr. Castaneda served Blue Rhino Corporation as its Chief Financial Officer from November 1997 until October 2004 and as a Director from September 1998 until April 2004. Mr. Castaneda helped lead Blue Rhino s initial public offering with Mr. Prim in May 1998. Mr. Castaneda began his career with Deloitte & Touche in 1988 and is a certified public accountant.

Michael S. Gunter Senior Vice President, Operations. Mr. Gunter has served as our Senior Vice President of Operations since March 2010 and previously served as our Vice President of Operations from our founding in October 2004 through February 2010. Prior to joining our Company, he served as the Senior Director of Strategy and Financial Analysis as well as the Director of Information Technology for Blue Rhino Corporation from 2000 until October 2004. Mr. Gunter served as an Artillery Officer in the United States Marine Corps from 1990 to 1996.

Duane G. Goodwin Senior Vice President, Business Development. Mr. Goodwin has served as our Senior Vice President of Business Development since February 2010. Prior to joining our Company, he served as Chief Supply Chain Officer for BlueLinx Corporation (a distributor of building products) from December 2005 until April 2009, as Senior Operations Consultant for Cerberus Capital Management (a private investment firm) from June 2005 until December 2005 and in various management roles for The Home Depot (a home

improvement retailer) from 1994 until January 2005. Before joining The Home Depot Mr. Goodwin was with Walmart Stores, Inc. (a mass merchant retailer), where he served in a variety of roles from 1985 through 1994.

Richard A. Brenner Director. Mr. Brenner has served on our Board of Directors since 2005. He has been the Chief Executive Officer of Amarr Garage Doors (a manufacturer and distributor of garage doors) since July 2002 and was its President from July 1993 until June 2002. Mr. Brenner also serves on several boards of private and nonprofit entities, including ABC of North Carolina, Idealliance and Wake Forest University Health Sciences, and was a member of the board of directors of Blue Rhino Corporation from 1998 to 2004. Mr. Brenner s significant executive and board service experience qualify him for service on our Board of Directors.

David W. Dupree Director. Mr. Dupree has served on our Board of Directors since April 2008. As a founder of The Halifax Group (a private equity group) in 1999, he serves as the Chief Executive Officer and Managing Director of Halifax. As the Chief Executive Officer and Managing Director of Halifax, Mr. Dupree has an active role with many of Halifax s portfolio companies, including serving as the managing member of GenPar Primo, LLC, the general partner of Primo Investors, L.P. Prior to co-founding Halifax, Mr. Dupree was a Managing Director and Partner with The Carlyle Group, where he was primarily responsible for investments in healthcare and related sectors. Mr. Dupree is also a Director Emeritus of Whole Foods Markets, Inc. where he served as a director from 1997 until 2008 and served on the Audit Committee and was Chairman of the Nominating and Governance Committee. Mr. Dupree also serves on several boards of private and non-profit organizations, including the Wake Forest University Board of Trustees. Mr. Dupree s business, financial, executive and managerial experience as well as service on the boards of various entities position him well to serve as a member of our Board of Directors.

Malcolm McQuilkin Director. Mr. McQuilkin has served on our Board of Directors since 2005. Since 1990, he has been Chief Executive Officer of Blue Rhino Global Sourcing, LLC (an import and design company and a wholly owned subsidiary of Ferrellgas Propane Partners). As the current Chief Executive Officer of Blue Rhino Global Sourcing, Mr. McQuilkin provides our Board of Directors with significant leadership and executive experience. Mr. McQuilkin s leadership abilities, his international business expertise (particularly with respect to outsourcing) and his extensive knowledge of complex financial and operational issues facing large companies qualify him to serve as a member of our Board of Directors.

David L. Warnock Director. Mr. Warnock has served on our Board of Directors since 2005. He is a founder and managing member of Camden Partners Holdings, LLC (a private investment management firm established in 1995 and formerly known as Cahill Warnock & Company, LLC). Mr. Warnock also serves as the managing member of the general partner of both Camden Partners Strategic Fund III, L.P. and Camden Partners Strategic Fund III-A, L.P. Mr. Warnock serves on the board of National American University, Inc., New Horizons Worldwide, Inc., Nobel Learning Communities, Inc., Questar Assessment, Inc., Towne Park Ltd., Ranir LLC, and CIBT School of Business and Technology Corp., and was a member of the board of directors of Blue Rhino Corporation from 2000 to 2004. Mr. Warnock brings to our Board of Directors a unique and valuable perspective from his years of experience in private investment management. Mr. Warnock s business acumen and his financial, managerial, leadership and board service experience qualify him to serve on our Board of Directors.

Our executive officers are elected by, and serve at the discretion of, our Board of Directors.

Board of Directors

Immediately following the closing of this offering, our Board of Directors will consist of five members. Our amended and restated bylaws that will be in effect immediately following the closing of this offering permit our Board of Directors to establish the authorized number of directors, and five directors are currently authorized. These amended and restated bylaws also provide that any vacancies or newly-created directorships may be filled only by the

remaining members of our Board of Directors.

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As of the closing of this offering, our amended and restated certificate of incorporation and amended and restated bylaws will provide for a classified board of directors consisting of three classes of directors, each serving staggered three-year terms, as follows:

the Class I directors will be Billy D. Prim and David W. Dupree, and their terms will expire at the annual meeting of stockholders to be held in 2011;

the Class II directors will be David L. Warnock and Malcolm McQuilkin, and their terms will expire at the annual meeting of stockholders to be held in 2012; and

the Class III director will be Richard A. Brenner, and his term will expire at the annual meeting of stockholders to be held in 2013.

Upon expiration of the term of a class of directors, directors for that class will be elected for a three-year term at the annual meeting of stockholders in the year in which that term expires. Each director s term continues until the election and qualification of that director s successor, or that director s earlier death, resignation or removal. Any increase or decrease in the number of directors will be distributed among the three classes so that, as nearly as possible, each class will consist of one-third of the directors. This classification of our Board of Directors may have the effect of delaying or preventing changes in control of our Company.

Director Independence

Upon the closing of this offering, we anticipate that our common stock will be listed on the Nasdaq Global Market. Under the applicable Nasdaq listing standards, independent directors must comprise a majority of a listed company s Board of Directors within a specified period following the closing of its initial public offering. In addition, Nasdaq s rules require that, subject to specific exceptions, each member of a listed company s audit committee and those members of the board of directors determining executive compensation and director nominations be independent. Audit committee members also must satisfy the independence criteria set forth in rule 10A-3 under the Securities Exchange Act of 1934. Under the Nasdaq rules, a director will only qualify as an independent director if, in the opinion of the company s board of directors, that person does not have a relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

In order to be considered independent for purposes of rule 10A-3 under the Securities Exchange Act of 1934, a member of an audit committee of a listed company may not, other than in his or her capacity as a member of the audit committee, the board of directors or any other board committee: (1) accept, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company or any of its subsidiaries; or (2) be an affiliated person of the listed company or any of its subsidiaries.

In March 2010, our Board of Directors undertook a review of its composition, the composition of its committees and the independence of each director. Based upon information requested from and provided by each director concerning his background, employment and affiliations, including family relationships, our Board of Directors has determined that none of Messrs. Brenner, Dupree, McQuilkin and Warnock, representing four of our five current directors, has a relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director and that each of these directors is independent as that term is defined under Nasdaq rules. Our Board of Directors also determined that Messrs. Brenner, Dupree and Warnock, who comprise our audit committee, Messrs. Dupree, McQuilkin and Warnock, who comprise our compensation committee, and Messrs. Brenner, Dupree, McQuilkin and Warnock, who comprise our nominating and governance committee, satisfy the independence standards for those committees established by applicable SEC rules and the rules of Nasdaq. In making these determinations, our Board of Directors considered the relationships that each non-employee director has with our

Company and all other facts and circumstances our Board of Directors deemed relevant in determining their independence, including the beneficial ownership of our capital stock by each

non-employee director. There is no family relationship between any director, executive officer or person nominated to become a director or executive officer.

Board Committees

Our Board of Directors has established an audit committee, a compensation committee and a nominating and governance committee. Our Board of Directors may establish other committees from time to time to facilitate our corporate governance.

Audit Committee. Our audit committee is comprised of Messrs. Brenner, Dupree and Warnock, with Mr. Dupree acting as chair. The principal responsibilities and functions of our audit committee are to assist the Board of Directors in fulfilling its oversight of (i) the integrity of our financial statements, (ii) the effectiveness of our internal controls over financial reporting, (iii) our compliance with legal and regulatory requirements, (iv) the qualifications and independence of our registered public accounting firm, and (v) the performance of our registered public accounting firm. In carrying out its oversight responsibilities and functions, our audit committee, among other things, oversees and interacts with our independent auditors regarding the auditors engagement and/or dismissal, duties, compensation, qualifications and performance; reviews and discusses with our independent auditors the scope of audits and our accounting principles, policies and practices; reviews and discusses our audited annual financial statements with our independent auditors and management; and reviews and approves or ratifies (if appropriate) related party transactions. Our audit committee also is directly responsible for the appointment, compensation, retention and oversight of our independent auditors.

Our Board of Directors has determined that Mr. Warnock is an audit committee financial expert, as defined under the applicable rules of the SEC, and that all members of the audit committee are independent within the meaning of the applicable Nasdaq listing standards and the independence standards of rule 10A-3 of the Securities Exchange Act of 1934. Each of the members of the audit committee meets the requirements for financial literacy under the applicable rules and regulations of the SEC and The Nasdaq Stock Market.

Compensation Committee. Our compensation committee is comprised of Messrs. Dupree, McQuilkin and Warnock, with Mr. Warnock acting as the chair. The principal functions of our compensation committee include (i) reviewing our compensation practices and policies, (ii) reviewing and approving the compensation for our senior executives, (iii) evaluating the performance of our senior executives, and (iv) assisting in the Company s compliance with the regulations of the SEC regarding executive compensation disclosure. Our Board of Directors has determined that all members of the compensation committee are independent within the meaning of the applicable Nasdaq listing standards.

Nominating and Governance Committee. Our nominating and governance committee is comprised of Messrs. Brenner, Dupree, McQuilkin and Warnock, with Mr. Brenner acting as the chair. The principal functions of our nominating and corporate governance committee are, among other things, to (i) establish membership criteria for our Board of Directors, (ii) establish and communicate to stockholders a method of recommending potential director nominees for the committee s consideration, (iii) identify individuals qualified to become directors consistent with such criteria and select the director nominees, (iv) plan for continuity on our Board of Directors, (v) recommend action to our Board of Directors upon any vacancies on our Board of Directors, (vi) facilitate the annual evaluation of the performance of our Board of Directors and its committees, (vii) periodically review management succession plans, and (viii) consider and recommend to our Board of Directors other actions relating to our Board of Directors, its members and its committees. Our Board of Directors has determined that all members of the nominating and governance committee are independent within the meaning of the applicable Nasdaq listing standards.

Code of Conduct

Our Board of Directors has adopted a Code of Business Conduct and Ethics that will become effective upon the closing of this offering. This code will apply to all of our employees, officers, and directors, including our

principal executive, financial and accounting officers and all persons performing similar functions. A copy of our Code of Business Conduct and Ethics will be available upon the closing of this offering on our corporate website (*www.primowater.com*). We expect that any amendments to the code, or any waivers of its requirements, will be disclosed on our website.

Director Compensation

We have not historically had any policy regarding compensation payable to our directors. Instead, we have from time to time in the past made awards of stock options to our non-employee directors. We made no such awards in 2008 or 2009 and we have not otherwise compensated our directors for services. In February 2010, we awarded each of our non-employee directors 60,000 shares of restricted common stock that vest in equal annual installments over a three-year period.

After giving effect to these awards, our non-employee directors hold the following equity awards received as director compensation:

Name	Stock Options (#)(1)	Restricted Stock (#)(2)
Richard A. Brenner	24,000	60,000
David W. Dupree		60,000
Malcolm McQuilkin	12,000	60,000
David L. Warnock	24,000	60,000

(1) These stock options were granted prior to 2008, are vested in their entirety and have an exercise price of $1.25 per share. As of December 31, 2009, the only outstanding equity awards were the stock options listed above.

(2) These shares of restricted stock were granted on February 18, 2010 and vest in equal annual installments over a three-year period.

In connection with this offering, our Board of Directors approved and adopted our Non-Employee Director Compensation Policy. Under the Non-Employee Director Compensation Policy, each non-employee director will receive an annual retainer of $25,000, to be paid one-half in restricted common stock and one-half in options to purchase common stock, granted on the first business day following each annual meeting of our stockholders. Additionally, non-employee directors will receive the following cash awards: (i) a $5,000 retainer for directors who also serve as committee chairs and a $2,500 retainer for other directors; (ii) $2,500 for each regularly scheduled Board of Directors meeting attended in person ($1,000 if attended telephonically); (iii) $1,000 for each ad hoc telephonic special Board of Directors meeting attended; (iv) $1,000 for each regularly scheduled committee meeting attended; and (v) $500 for each ad hoc telephonic committee meeting attended. Grants made under the Non-Employee Director Compensation Policy will be made pursuant to the 2010 Omnibus Long-Term Incentive Plan and will vest in full on the day immediately following the first anniversary of the grant date.

Compensation Committee Interlocks and Insider Participation

Upon the closing of this offering, our compensation committee will consist of Messrs. Dupree, McQuilkin and Warnock. During 2009, Messrs. Prim, Brenner, McQuilkin and Warnock served on our compensation committee. Mr. Filipowski, a former member of our Board of Directors, also served on our compensation committee through the

end of January 2009.

Interlocks

With the exception of Mr. Prim who served on our compensation committee through the end of 2009, none of the members of our current compensation committee or our compensation committee during 2009 is or has at any time been an officer or employee of ours. None of our executive officers has served as a member of the board of directors, or as a member of the compensation or similar committee, of any entity that has one or more executive officers who served on our Board of Directors or compensation committee during 2009.

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The following paragraphs provide a description of certain transactions between the company and current members of the compensation committee and former members of the compensation committee who served at any time during 2009. See Related Party Transactions for additional information regarding these transactions.

Sale of Subordinated Convertible Notes and Warrants

Messrs. Prim, Dupree, McQuilkin and Warnock (either individually or through an affiliated entity) purchased an aggregate of $3.04 million of our 2011 Notes and an aggregate of 225,185 warrants to purchase shares of our common stock in a private placement on December 30, 2009. We issued a total of $15.0 million of 2011 Notes and a total of 1,111,109 warrants in that private placement. The exercise price of these warrants is either (a) $1.25 per share or (b) following a public offering in which we realize at least $30.0 million in net proceeds, 80% of the per share price of the shares issued in the offering. The following table sets forth certain information regarding such persons purchase of the 2011 Notes and the related warrants.

Name	Affiliated Investor	Principal Amount of Notes Purchased ($)	Warrants (#)
Billy D. Prim		540,000	40,000
David W. Dupree		100,000	7,407
Malcolm McQuilkin	Malcolm McQuilkin Living Trust	1,000,000	74,074
David L. Warnock	Camden Partners Strategic Fund III, LP	1,344,140	99,566
David L. Warnock	Camden Partners Strategic Fund III-A, LP	55,860	4,138

Sale of Series C Convertible Preferred Stock and Warrants

Messrs. Prim, Dupree, McQuilkin and Warnock (either individually or through an affiliated entity) purchased an aggregate of 5,826,947 shares of Series C convertible preferred stock and warrants to purchase an aggregate of 582,695 shares of common stock at an exercise price of $1.98 per share in private placement transactions between December 14, 2007 and May 20, 2008. We issued a total of 12,520,001 shares of Series C convertible preferred stock and warrants to purchase 1,252,001 shares of common stock in connection with these private placement transactions. The following table sets forth certain information regarding such persons ownership of those shares and warrants.

Name	Affiliated Investor	Shares Purchased (#)	Warrants Purchased (#)	Amount Paid for Shares and Warrants ($)
Billy D. Prim		512,363	51,237	1,229,671
David W. Dupree	Primo Investors, L.P.	4,281,250	428,125	10,275,000
Malcolm McQuilkin	Malcolm McQuilkin Living Trust	200,000	20,000	480,000
David L. Warnock	Camden Partners Strategic Fund III, LP	800,084	80,008	1,920,202
David L. Warnock	Camden Partners Strategic Fund III-A, LP	33,250	3,325	79,800

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Sale of Series B Preferred Stock and Warrants

Messrs. Prim, McQuilkin, Warnock and Filipowski (either individually or through or with an affiliated entity or person) purchased an aggregate of 8,999,691 shares of Series B preferred stock and warrants to purchase an aggregate of 2,402,916 shares of common stock at an exercise price of $1.25 per share in private placement transactions between April 28, 2006 and June 30, 2007. We issued a total of 23,280,221 shares of Series B preferred stock and warrants to purchase a total of 6,215,813 shares of common stock in these private placement transactions. The following table sets forth certain information regarding such persons ownership of those shares.

Name	Affiliated Investor	Shares Purchased (#)	Warrants Purchased (#)	Amount Paid for Shares and Warrants ($)
Billy D. Prim		5,164,846	1,379,013	5,164,846
Billy D. Prim	Deborah Prim	70,000	18,690	70,000
Malcolm McQuilkin	Malcolm McQuilkin Living Trust	600,000	160,200	600,000
David L. Warnock	Camden Partners Strategic Fund III, LP	2,880,300	769,040	2,880,300
David L. Warnock	Camden Partners Strategic Fund III-A, LP	119,700	31,959	119,700
Andrew J. Filipowski		164,845	44,014	164,845

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EXECUTIVE COMPENSATION

Compensation Discussion and Analysis

The following discussion and analysis of compensation arrangements of our (1) principal executive officer (Billy D. Prim), (2) principal financial officer (Mark Castaneda) and (3) three most highly compensated executive officers other than our principal executive officer and principal financial officer who were serving as executive officers on December 31, 2009 (Michael S. Gunter, Richard E. Belmont and Brent C. Boydston, and collectively with Messrs. Prim and Castaneda, our NEOs) should be read together with the compensation tables and related disclosures set forth below. This discussion contains forward-looking statements that are based on our current considerations, expectations and determinations regarding future compensation programs. The actual amount and form of compensation and the compensation programs that we adopt may differ materially from current or planned programs as summarized in this discussion.

Introduction

Our compensation discussion and analysis discusses the total compensation for our NEOs, and it describes our overall compensation philosophy, objectives and practices. Our compensation philosophy and objectives generally apply to all of our employees and all of our employees are eligible to participate in the main components our compensation program consisting of:

- base salary;
- annual cash bonus; and
- equity compensation.

The relative value of each of these components for individual employees varies based on job role and responsibility, as well as our financial performance.

Compensation Philosophy and Objectives

Our compensation approach is necessarily tied to our stage of development. Our compensation philosophy is to offer our executive officers, including our NEOs, compensation and benefits that are competitive and meet our goals of attracting, retaining and motivating highly skilled management, which is necessary to achieve our financial and strategic objectives and create long-term value for our stockholders. Accordingly, our executive officer compensation program is designed to link annual and long-term cash and stock incentives to the achievement of Company and individual performance goals and to align the interests of executive officers with the creation of stockholder value.

We believe compensation should be determined within a framework that is intended to reward individual contribution and the achievement of Company objectives. Within this overall philosophy, our objectives are to:

- attract, retain and motivate our executives by providing a total compensation program that takes into consideration competitive market requirements and strategic business needs;
- align the financial interests of executive officers with those of our stockholders, both in the short and long term;

provide incentives for achieving and exceeding annual and long-term performance goals; and

appropriately reward executive officers for creating long-term stockholder value.

Each of Messrs. Prim, Castaneda and Gunter has entered into an employment agreement with the Company in connection with this offering. We have also entered into an employment agreement in connection with this offering with Duane G. Goodwin who joined our Company as Senior Vice President, Business Development in February 2010. The material terms of those employment agreements are described below.

Role of Directors and Executive Officers in Setting Compensation

Prior to this offering, we were a privately-held company. As a result, we have not been subject to any stock exchange listing or SEC rules requiring a majority of our Board of Directors to be independent or relating to the formation and functioning of Board committees, including our compensation committee. Historically, we have informally considered the competitive market for corresponding positions within comparable geographic areas and companies of similar size and stage of development, including other small, high-growth public companies. This consideration was based on the general knowledge possessed by members of our compensation committee and also included consultations with our Chief Executive Officer. As we gain experience as a public company, we expect that the specific direction, emphasis and components of our executive compensation program will continue to evolve. For example, over time, we expect to reduce our reliance upon subjective determinations in favor of a more empirically based approach that could involve, among other practices, benchmarking the compensation paid to our NEOs against peer companies that we identify and the use of clearly defined, objective targets to determine incentive compensation awards.

The compensation committee typically considers, but is not required to accept, our Chief Executive Officer s evaluation regarding the performance and recommendation regarding proposed base salary and bonus and equity awards for the other NEOs, as well as himself. The compensation committee may also request the assistance of our Chief Financial Officer in evaluating the financial, accounting and tax implications of various compensation awards paid to the NEOs. However, our Chief Financial Officer does not recommend or determine the amounts or types of compensation paid to the NEOs. Our Chief Executive Officer and certain of our other NEOs may attend compensation committee meetings, as requested by the chairman of the compensation committee. Our NEOs, including our Chief Executive Officer, typically do not attend any portion of the compensation committee meetings during which their compensation is established and approved.

We believe the levels of compensation we provide should be competitive, reasonable and appropriate for our business needs and circumstances. To date, the compensation committee has not engaged a compensation consultant. Rather, the compensation committee and our Chief Executive Officer applied subjective discretion to make compensation decisions and they have not used a specific formula or matrix to set compensation in relation to compensation paid by other companies. To date, our compensation committee has not established any percentile targets for the levels of compensation provided to our NEOs. Similarly, the compensation committee has not performed competitive reviews of our compensation programs with those of similarly-situated companies, nor have we engaged in benchmarking of compensation paid to our NEOs. Our historical approach has been to consider competitive compensation practices and other factors such as how much compensation was necessary to recruit and retain an executive and individual performance rather than establishing compensation at specific benchmark percentiles. This approach has enabled us to respond to dynamics in the labor market and provided us with flexibility in maintaining and enhancing our NEOs engagement, focus, motivation and enthusiasm for our future. However, as mentioned above, we expect to build some of these practices into our compensation approach over time as we review, evaluate and refine our compensation policies and practices as a public company.

The amount of past compensation, including annual discretionary bonus awards and amounts realizable from prior stock option awards, is generally not a significant factor in the compensation committee s considerations because these awards would have been earned based on performance in prior years. The compensation committee does, however, consider prior awards when considering the retention aspects of our compensation program.

Our NEOs are not subject to mandated stock ownership or stock retention guidelines. It is the belief of the compensation committee that the equity component of our executive compensation program ensures that our

NEOs are also owners and those components work to align the NEOs goals with the best interests of our stockholders.

Elements of Our Executive Compensation Program

The principal elements of our executive compensation program have to date been base salary, a discretionary annual cash bonus and long-term equity compensation in the form of stock options. Each of these compensation elements satisfies one or more of our compensation objectives.

We have not adopted any policies with respect to long-term versus currently-paid compensation, but feel that both elements are necessary for achieving our compensation objectives. Currently-paid salary compensation provides financial stability for each of our NEOs and annual increases in base salary provide a reward for short-term Company and individual performance. Annual cash bonuses likewise provide a reward for short-term Company and individual performance. Long-term equity compensation rewards achievement of strategic long-term objectives and contributes toward overall stockholder value. Similarly, while we have not adopted any policies with respect to cash versus non-cash compensation (or among different forms of non-cash compensation), we feel that it is important to encourage or provide for a meaningful amount of equity ownership by our NEOs to help align their interests with those of stockholders, one of our compensation objectives. We have also used equity compensation in order to preserve the Company s cash to the extent practicable in order to facilitate our growth and development. We combine the compensation elements for each NEO in a manner that the compensation committee believes, in its discretion and judgment, is consistent with the executive s contributions to our Company and our overall goals with respect to executive compensation.

Base Salary

We believe that a competitive base salary is an important component of compensation as it provides a degree of financial stability for our NEOs and is critical to recruiting and retaining our executives. Base salary is also designed to recognize the scope of responsibilities placed on each NEO and reward each executive for his or her unique leadership skills, management experience and contributions. We make a subjective determination of base salary after considering such factors collectively.

Annual Bonuses

Our cash bonus compensation is designed to reward achievement of goals that support our objective of enhancing stockholder value and motivating executives to achieve superior performance in their areas of responsibility. We generally utilize incentive plans that tie payment of cash bonuses to the Company s achievement of certain objectives, including revenue targets, EBITDA targets and new selling locations. Our incentive plans also base a portion of the bonus payment on the achievement of individual initiatives that are determined by the Chief Executive Officer, or, in the case of the Chief Executive Officer, by the compensation committee. We determined not to establish an annual incentive plan for 2009 given our desire to reduce expenses in the face of uncertain U.S. economic conditions. As a result, we paid no bonuses to our NEOs with respect to the 2009 performance year.

We have, however, established such an annual incentive plan for 2010, which includes an opportunity for a cash award and an equity award as follows:

Cash award:

o A cash incentive pool will be created based upon the amount by which the Company s actual earnings before interest, taxes, depreciation and amortization (EBITDA) for 2010 exceeds target EBITDA (based on the Company s 2010 budget). This cash pool will be funded as follows:

- 50% of the first $1.0 million of actual EBITDA in excess of target EBITDA; plus

- n 30% of the next $1.0 million of actual EBITDA in excess of target EBITDA; plus
- n 20% of any actual EBITDA more than $2.0 million in excess of target EBITDA.

o Each participant in the annual incentive plan for 2010 will be entitled to a portion of the cash incentive pool equal to that participant s individual 2010 salary over the total 2010 salaries of all the participants in the 2010 annual incentive plan multiplied by the total amount in the cash incentive pool.

Equity award:

o Target amounts are based on Company and employee-specific performance;

o 50% of the award will be payable in stock options and 50% will be payable in restricted stock; and

o Actual awards will be based on the compensation committee s subjective evaluation of the Company s and each individual s performance.

Long-Term Equity Compensation

Historically, we have provided long-term equity compensation primarily through grants of stock options. However, no such equity compensation was paid in 2009 other than certain awards that were made with respect to 2008 performance. Beginning in 2010, we intend to use a combination of stock options and restricted stock.

We have granted stock options and intend to grant stock options and restricted stock through annually-adopted executive incentive plans, initial grants to new employees and, on occasion, through additional grants approved by our Board of Directors or the compensation committee. We believe that such grants further our compensation objectives of aligning the interests of our NEOs with those of our stockholders, encouraging long-term performance, and providing a simple and easy-to-understand form of equity compensation that promotes executive retention. We view such grants both as incentives for future performance and as compensation for past accomplishments.

We generally have used stock options in the past, rather than other forms of long-term incentives, because they create value for the executive only if stockholder value is increased through appreciation of our share price. Prior to this offering, all stock option grants were made pursuant to our 2004 Stock Plan. Historically, the exercise price of our stock options has been at least equal to the fair market value of our common stock on the date of grant. Prior to this offering, the fair market value of our common stock has been established by our Board of Directors using factors it considered appropriate for a reasonable valuation. Following this offering, the fair market value of our common stock will be the closing price of our common stock on the Nasdaq Global Market on the date of the grant, provided our shares are approved for listing on the Nasdaq Global Market. As a privately owned company prior to the date of this offering, we have not established a program, plan or practice pertaining to the timing of stock option grants to executive officers coinciding with the release of material non-public information. We have adopted a policy, to take effect upon completion of this offering, that provides for our compensation committee to approve stock option grants up to four times per year at its regularly scheduled quarterly meetings, and further provides that such grants will be effective on the third trading day following the date of the next public disclosure of our financial results following the date of each such meeting.

Following this offering, we anticipate that we will continue to use stock option grants, as well as restricted stock and other forms of equity compensation. We believe restricted stock aligns the interests of our executive officers with

those of our stockholders and serves as a retention tool as it will typically be subject to a multi-year vesting period. Following this offering, all equity award grants will be made pursuant to our 2010 Omnibus Long-Term Incentive Plan. The exercise price of stock options will be based on the fair market value of our common stock on the grant date as described above.

Our Chief Executive Officer received an initial stock option grant to purchase 100,000 shares of our common stock in 2004 in connection with the formation of the Company. Our other NEOs received stock option grants in connection with their initial hire. The number of stock options granted to our NEOs in connection with their initial hire was determined based upon negotiations with each executive, represented the number necessary to recruit each executive from his then-current position and reflected our Board of Directors subjective evaluation of the executive s experience and potential for future performance.

We have made additional discretionary grants of equity compensation to all of our executive officers from time to time, as determined by our Board of Directors or the compensation committee taking into consideration factors such as individual performance and competitive market conditions.

Perquisites and Other Benefits

As a general matter, we do not intend to offer perquisites or other benefits to any executive officer, including the NEOs, with an aggregate value in excess of $10,000 annually, because we believe we can provide better incentives for desired performance with compensation in the forms described above. We recognize that, from time to time, it may be appropriate to provide some perquisites or other benefits in order to attract, motivate and retain our executives, with any such decision to be reviewed and approved by the compensation committee as needed.

Our executive officers are eligible to participate in standard employee benefit plans, including medical, dental, vision, life and any other employee benefit or insurance plan made available to employees. We maintain a 401(k) plan, which is intended to be a tax-qualified defined contribution plan under Section 401(k) of the Internal Revenue Code of 1986, as amended, or the Code. In general, all of our employees are eligible to participate in this plan. The 401(k) plan includes a salary deferral arrangement pursuant to which participants may elect to reduce their current compensation by up to 90% or the statutory limit, $16,500 in 2009, whichever is less, and have the amount of the reduction contributed to the 401(k) plan. We made no matching contributions during 2009; however, in 2010 our Board of Directors established a Company match of up to 50% of employee contributions up to 6% of their salaries, with 50% of the matching amount being contingent upon our achievement of certain objectives to be determined by our Board of Directors.

Employment and Severance and Change of Control Benefits

We believe that a strong, experienced management team is essential to the best interests of the Company and our stockholders. We recognize that the possibility of a change of control could arise and that such a possibility could result in the departure or distraction of members of the management team to the detriment of our Company and our stockholders. We have entered into new employment agreements with certain of our NEOs in connection with this offering, which are intended to minimize employment security concerns arising in the course of negotiating and completing a change of control transaction. A more detailed description of the change of control provisions provided in these employment agreements is available under the section captioned Employment Agreements and Change of Control Arrangements below, and the change of control benefits are quantified in the section captioned Potential Payments Upon Termination or Change of Control.

Analysis of 2009 Compensation for Named Executive Officers

Base Salary

In light of the uncertain U.S. economic conditions, we did not increase the base salaries of our NEOs for 2009 compared to 2008.

During 2008 and 2009, the base salary of our Chief Executive Officer, Billy D. Prim, was $400,000 per year.

Mark Castaneda, our Chief Financial Officer, became an employee of the Company in 2008. At that time, our Board of Directors set his base salary at $225,000 per year. Mr. Castaneda s 2009 base salary remained at $225,000 per year.

During 2008 and 2009, the base salary of Michael S. Gunter, our Senior Vice President, Operations, was $173,363.

Richard E. Belmont, our Vice President, Products, became an employee of the Company in 2008. At that time, our Board of Directors set his base salary at $183,195 per year. Mr. Belmont s 2009 base salary remained at $183,195 per year.

During 2008 and 2009, the base salary of Brent C. Boydston, our former Vice President, Business Development and current Vice President, National Accounts, was $217,350.

In February 2010, we approved base salaries for our NEOs as follows:

Name	**Amount ($)**
Billy D. Prim	400,000
Mark Castaneda	250,000
Michael S. Gunter	225,000
Richard E. Belmont	190,000
Brent C. Boydston	150,000

Annual Cash Bonuses

We did not make any cash bonus payments to NEOs for 2009. The compensation committee decided not to establish an annual incentive plan for 2009 given its desire to reduce expenses in the face of uncertain U.S. economic conditions. We paid the following cash bonuses to our NEOs for 2008:

Name	**Amount ($)**
Billy D. Prim	
Mark Castaneda	30,000
Michael S. Gunter	22,000
Richard E. Belmont	15,300
Brent C. Boydston	14,000

Long-Term Equity Compensation

We did not make any equity awards to NEOs for 2009 because, as noted above, the compensation committee determined not to establish an annual incentive plan for 2009. We awarded our NEOs options to purchase the following number of shares (at an exercise price of $1.25 per share) in 2009 for 2008 performance:

Name	**Number of Options**
Billy D. Prim	

Mark Castaneda	40,000
Michael S. Gunter	
Richard E. Belmont	23,800
Brent C. Boydston	21,000

Tax Considerations

Other than our Chief Executive Officer, we have not provided any executive officer or director with a gross-up or other reimbursement for tax amounts the executive might pay pursuant to Section 280G or Section 409A of the

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Internal Revenue Code. As described in the section below captioned Employment Agreements and Change of Control Arrangements, any payments our Chief Executive Officer receives in connection with a change of control may be subject to increase to cover any excise tax imposed by Section 280G of the Internal Revenue Code.

Section 280G and related Code sections provide that executive officers, directors who hold significant stockholder interests and certain other service providers could be subject to significant additional taxes if they receive payments or benefits in connection with a change of control that exceed certain limits, and that we or our successor could lose a deduction on the amounts subject to the additional tax. Section 409A also imposes additional significant taxes on the individual in the event that an executive officer, director or service provider receives deferred compensation that does not meet the requirements of Section 409A.

Because of the limitations of Internal Revenue Code Section 162(m), our federal income tax deduction for compensation paid to our Chief Executive Officer and to certain other highly compensated executive officers (other than our Chief Financial Officer) may be limited if the compensation exceeds $1,000,000 per person during any fiscal year, unless it is performance-based under Code Section 162(m) or meets another exception to the deduction limits. In addition to salary and bonus compensation, upon the exercise of stock options that are not treated as incentive stock options, the excess of the current market price over the option price, or the option spread, is treated as compensation and accordingly, in any year, such exercise may cause an officer s total compensation to exceed $1,000,000. However, option compensation will not be subject to the $1,000,000 cap on deductibility if the options meet certain requirements, and in the past we have granted options that we believe met those requirements. Additionally, under a special Code Section 162(m) transition rule, any compensation paid pursuant to a compensation plan in existence before the effective date of this public offering will not be subject to the $1,000,000 limitation until the first meeting of stockholders at which directors are elected after the close of the third calendar year following the year in which the public offering occurs, unless the compensation plan is materially modified. While the compensation committee cannot predict how the deductibility limit may impact our compensation programs in future years, the compensation committee intends to maintain an approach to executive compensation that links pay to performance. In addition, while the compensation committee has not adopted a formal policy regarding tax deductibility of compensation paid to our NEOs, the compensation committee intends to consider tax deductibility under Code Section 162(m) as a factor in compensation decisions.

Risk Analysis of Compensation Program

The compensation committee has reviewed the Company s compensation program and does not believe that it encourages excessive or unnecessary risk taking. Base salaries are fixed in amount and thus do not encourage risk taking. By utilizing annual cash bonuses that are tied to individual and Company-wide performance measures and long-term equity compensation as a significant portion of total compensation, the compensation committee believes that it has aligned our executive officers objectives with those of our long-term stockholders.

Conclusion

The compensation committee believes that our executive leadership is a key element to our success and that the compensation package offered to our NEOs is a key element in attracting and retaining the appropriate personnel.

The compensation committee believes it has maintained compensation for our NEOs at levels that are reflective of the talent and success of the individuals being compensated, and with the inclusion of additional compensation directly tied to performance, the compensation committee believes executive compensation will be sufficiently comparable to its industry peers to allow us to retain our key personnel at costs which are appropriate for us.

The compensation committee will continue to develop, analyze and review its methods for aligning our executive officers long-term compensation with the benefits generated for stockholders. The compensation committee believes the idea of creating ownership helps align management s interests with the interests of stockholders. The compensation committee has no pre-determined timeline for implementing new or ongoing

long-term incentive plans. New plans are reviewed, discussed and implemented as the compensation committee believes it is necessary or appropriate as a measure to incentivize, retain and reward our NEOs.

Summary Compensation Table for 2009

The following table sets forth information regarding the compensation earned in 2009 for our NEOs.

Name and Principal Position	Year	Salary ($)	Option Awards (#)[1]	All Other Compensation ($)[2]	Total ($)
Billy D. Prim Chairman, Chief Executive Officer and President	2009	400,000		138	400,138
Mark Castaneda Chief Financial Officer	2009	225,000	19,399	93	244,492
Michael S. Gunter Senior Vice President, Operations	2009	173,363		62	173,425
Richard E. Belmont Vice President, Products	2009	183,195	11,542	143	194,880
Brent C. Boydston Vice President, Business Development[3]	2009	217,350	10,184	62	227,596

(1) Represents the aggregate grant date fair value of stock options awarded in 2009 calculated in accordance with Financial Accounting Standards Board Accounting Standards Codification 718 (formerly referred to as SFAS 123(R)). For a description of the assumptions used in estimating the grant date fair value of the option awards as reported in this column, see note 9 to our consolidated financial statements for the year ended December 31, 2009.

(2) Amounts shown in this column consist of life insurance premiums paid on behalf of each NEO.

(3) Mr. Boydston served as Vice President, Business Development through February 15, 2010. Mr. Boydston currently serves the Company as Vice President, National Accounts.

Grants of Plan-Based Awards for 2009

The following table sets forth certain information regarding grants of plan-based awards to our NEOs in 2009.

	All Other Option Awards: Number of Securities Underlying	Exercise or Base Price of Option	Grant Date Fair Value of Option

Name	Grant Date	Options (#)[1]	Awards ($/Sh)	Awards ($)[2]
Billy D. Prim				
Mark Castaneda	1/29/2009	40,000	1.25	19,399
Michael S. Gunter				
Richard E. Belmont	1/29/2009	23,800	1.25	11,542
Brent C. Boydston	1/29/2009	21,000	1.25	10,184

(1) We granted the stock options listed in this column under our 2004 Stock Plan in 2009 for 2008 performance. The vesting schedule applicable to each award is set forth below in the section entitled Outstanding Equity Awards at December 31, 2009.

(2) Represents the aggregate grant date fair value calculated in accordance with Financial Accounting Standards Board Accounting Standards Codification 718 (formerly referred to as SFAS 123(R)). For a description of the assumptions used in estimating such fair value, see note 9 to our consolidated financial statements for the year ended December 31, 2009.

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Outstanding Equity Awards at December 31, 2009

The following table sets forth information regarding outstanding equity awards held by our NEOs as of December 31, 2009.

	Option Awards			
Name	Number of Shares Underlying Unexercised Options (#) Exercisable	Number of Shares Underlying Unexercised Options (#) Unexercisable	Option Exercise Price ($)	Option Expiration Date
Billy D. Prim	100,000		1.00	11/01/14
	225,000		1.00	01/01/16
	10,000	10,000(1)	1.25	01/25/17
	100,000		1.98	05/01/18
Mark Castaneda	37,500	112,500(2)	1.98	05/01/18
		40,000(3)	1.25	01/29/19
Michael S. Gunter	100,000		1.00	11/01/14
	90,000		1.00	01/01/16
	4,187	4,188(1)	1.25	01/25/17
		53,125(4)	1.25	01/25/17
Richard E. Belmont	75,000	25,000(5)	1.25	09/11/16
	4,425	4,425(1)	1.25	01/25/17
	33,188		1.98	05/01/18
		23,800(3)	1.25	01/29/19
Brent C. Boydston	100,000		1.00	11/01/14
	82,500		1.00	01/01/16
	5,250	5,250(1)	1.25	01/25/17
		18,750(4)	1.25	01/25/17
	39,375		1.98	05/01/18
		21,000(3)	1.25	01/29/19

(1) These options vest in two equal annual installments on January 1, 2010 and January 1, 2011.

(2) These options vest in three equal annual installments on May 1, 2010, May 1, 2011 and May 1, 2012.

(3) These options vested in their entirety on January 30, 2010.

(4) These options vested in their entirety on January 1, 2010.

(5) These options vest in their entirety on September 11, 2010.

On April 29, 2010, our Board of Directors determined that all outstanding unvested options will accelerate and be fully vested upon the closing of the initial public offering described in this prospectus. This accelerated vesting will result in a non-cash charge of approximately $300,000.

Option Exercises and Stock Vested for 2009

No stock options held by our NEOs were exercised during 2009. As of December 31, 2009, none of our NEOs held any unvested restricted stock.

Employment Agreements and Change of Control Arrangements

The following summaries of the employment agreements of Messrs. Prim, Castaneda and Gunter describe the new employment agreements with such individuals that have been entered into in connection with this offering.

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Employment Agreement with Mr. Prim

Mr. Prim s employment agreement provides for a base annual salary of $400,000, which may be adjusted up but not down by our Board of Directors. Mr. Prim will also be eligible to receive bonuses and awards of equity and non-equity compensation as approved by our Board of Directors. The employment agreement entitles Mr. Prim to participate in all other Company benefits generally available to other senior executives. Mr. Prim s employment agreement also provides for: (i) an annual automatic cost of living increase to base salary based on the Consumer Price Index; (ii) long-term disability coverage at 100% of base annual salary; (iii) an annual physical paid for by the Company; and (iv) Company s payment of certain attorneys fees incurred in the event Mr. Prim has to take action to enforce his rights under the employment agreement. We have agreed to maintain insurance coverage for and indemnify Mr. Prim in connection with his capacity as our director and officer.

Our employment agreement with Mr. Prim provides for an initial three-year employment term commencing April 1, 2010 and automatically extending for additional one-year periods unless terminated by Mr. Prim or us upon at least 90 days prior written notice of intention not to renew. The agreement may also be terminated by us or Mr. Prim for other reasons and, subject to the conditions set forth in the employment agreement, provides for certain payments to Mr. Prim upon a termination of his employment or a change of control of the Company, as described below.

If Mr. Prim s employment is terminated for any reason, he will be entitled to continued coverage under our directors and officers insurance policy and to continued rights to corporate indemnification, each as offered to (and on the same terms as) other executive officers for six years following his termination date. Unless Mr. Prim is terminated for Cause or he resigns without Good Reason (each as defined below), he will be entitled to any applicable prorated annual bonus for such year and any accrued but unpaid annual bonus for the immediately preceding year. Additionally, if Mr. Prim is terminated without Cause, resigns for Good Reason or we do not renew his employment agreement at the end of its term, Mr. Prim will be entitled to (a) severance payments in an amount equal to (i) his highest annual base salary in effect during the 12 months immediately prior to his termination date plus (ii) the average annual bonus earned by him for the most recent two fiscal years ending prior to his termination date; (b) coverage under health, dental, life, accident, disability and similar benefit plans offered to (and on the same terms as) other executive officers for 12 months following his termination date; and (c) the immediate vesting of any restricted stock, stock option or other equity compensation awards scheduled to vest within six months after his termination date.

If Mr. Prim is terminated without Cause or if he resigns for Good Reason within two years following a Change of Control (as defined below), he will be entitled to (a) any applicable prorated annual bonus for such year and any accrued but unpaid annual bonus for the immediately preceding year; (b) severance payments in an amount equal to two times the sum of (i) his highest annual base salary in effect during the 12 months immediately prior to his termination date plus (ii) the average annual bonus earned by Mr. Prim for the most recent two fiscal years ending prior to his termination date; and (c) coverage under health, dental, life, accident, disability and similar benefit plans offered to (and on the same terms as) the other executive officers for the 24 months following his termination date. In addition, any restricted stock, stock option or other equity compensation awards will immediately vest as of the date of the Change of Control.

Mr. Prim s employment agreement provides that a Change of Control occurs when:

any individual, entity or group (a Person) becomes the beneficial owner of 50% or more of either (A) the then-outstanding shares of common stock of the Company (the Outstanding Company Common Stock) or (B) the combined voting power of the then-outstanding voting securities of the Company entitled to vote generally in the election of directors (the Outstanding Company Voting Securities); provided, however, that the following acquisitions shall not constitute a Change of Control: (i) any acquisition directly from the Company,

(ii) any acquisition by the Company, (iii) any acquisition by any employee benefit plan (or related trust) sponsored or maintained by the Company, or (iv) any acquisition pursuant to a transaction that complies with (A), (B) and (C) in the third bullet point below;

individuals who, as of the effective date of the agreement, constitute the board of directors of the Company (the Incumbent Board) cease for any reason to constitute at least a majority of the board of directors; provided, however, that any individual becoming a director subsequent to the effective date of the agreement whose election, or nomination for election by the Company s stockholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board shall be considered as though such individual was a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial assumption of office occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the board of directors;

there is consummation of a reorganization, merger or similar transaction involving the Company or any of its subsidiaries, a sale or other disposition of all or substantially all of the assets of the Company, or the acquisition of assets or stock of another entity by the Company or any of its subsidiaries (each, a Business Combination), in each case unless, following such Business Combination, (A) all or substantially all of the individuals and entities that were the beneficial owners of the Outstanding Company Common Stock and the Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 50% of the then-outstanding shares of common stock and the combined voting power of the entity resulting from such Business Combination in substantially the same proportions as their ownership immediately prior to such Business Combination of the Outstanding Company Common Stock and the Outstanding Company Voting Securities, as the case may be, (B) no Person beneficially owns, directly or indirectly, 20% or more of the then-outstanding shares of common stock of the corporation resulting from such Business Combination or the combined voting power of the then-outstanding voting securities of such corporation, except to the extent that such ownership existed prior to the Business Combination, and (C) at least a majority of the members of the board of directors of the entity resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement or of the action of the Board providing for such Business Combination; or

the stockholders of the Company approve a complete liquidation or dissolution of the Company.

The initial public offering described in this prospectus is not an event that would trigger change of control payments under Mr. Prim s employment agreement.

As defined in Mr. Prim s employment agreement, Cause means (a) continued willful failure to substantially perform his duties with the Company, (b) willful engaging in misconduct materially and demonstrably injurious to the Company or (c) his uncured material breach of the agreement. Mr. Prim may terminate his employment for Good Reason (i) if there is a material reduction in his duties or responsibilities, (ii) if he is required to relocate to an employment location more than 50 miles from his initial employment location, or (iii) upon our uncured material breach of the agreement.

If Mr. Prim becomes subject to excise taxes under Section 4999 of the Internal Revenue Code, we will make a tax gross-up payment to him in an amount sufficient to cover such excise taxes and any interest or penalties thereon.

Mr. Prim s employment agreement also contains confidentiality provisions and non-competition and non-solicitation covenants prohibiting, among other things, Mr. Prim s competition with us or his solicitation of our customers, suppliers or employees for the 12-month period following the termination of his employment.

Employment Agreements with Messrs. Castaneda and Gunter

The Company s employment agreements with Messrs. Castaneda and Gunter are substantially similar to our employment agreement with Mr. Prim, except that the economic terms differ among the agreements and their agreements do not provide for: (i) an annual automatic cost of living increase to base salary; (ii) additional long-term

disability coverage; (iii) a Company-paid annual physical; (iv) Company payment of certain attorney fees; and (v) a Section 4999 excise tax gross-up payment to cover certain taxes and penalties. Mr. Castaneda s employment agreement provides for a base annual salary of $250,000 and Mr. Gunter s employment agreement provides for a base annual salary of $225,000, which base salaries may be adjusted up but not down by our Board of Directors. Messrs. Castaneda and Gunter will also each be eligible to receive bonuses and awards of equity and non-equity compensation as approved by our Board of Directors. The employment agreements entitle each of Messrs. Castaneda and Gunter to participate in all other Company benefits generally available to other senior executives. We have agreed to maintain insurance coverage for and indemnify each of Messrs. Castaneda and Gunter in connection with their respective capacities as officers.

Our employment agreements with each of Messrs. Castaneda and Gunter provide for initial three-year employment terms commencing April 1, 2010 and automatically extending for additional one-year periods unless terminated by the NEO or us upon at least 90 days prior written notice of intention not to renew. The agreement may also be terminated by us or the NEO for other reasons and, subject to the conditions set forth in the employment agreement, provides for certain payments to be made to such NEO upon a termination of his employment or a change of control of the Company, as described below.

If either of Messrs. Castaneda or Gunter is terminated for any reason, he will be entitled to continued coverage under our directors and officers insurance policy and continued rights to corporate indemnification, each as offered to (and on the same terms as) other executive officers for six years following his termination date. Unless either of Messrs. Castaneda or Gunter is terminated for Cause or resigns without Good Reason (each as defined above with respect to Mr. Prim s employment agreement), he will be entitled to any applicable prorated annual bonus for such year and any accrued but unpaid annual bonus for the immediately preceding year. Additionally, if either of Messrs. Castaneda or Gunter is terminated without Cause, resigns for Good Reason or we do not renew his employment agreement at the end of its term, he will be entitled to (a) severance payments in an amount equal to (i) his highest annual base salary in effect during the 12 months immediately prior to his termination date plus (ii) the average annual bonus earned by him for the most recent two fiscal years ending prior to his termination date; (b) coverage under health, dental, life, accident, disability and similar benefit plans offered to (and on the same terms as) other executive officers for 12 months following his termination date; and (c) the immediate vesting of any restricted stock, stock option or other equity compensation awards scheduled to vest within six months after his termination date.

If either of Messrs. Castaneda or Gunter is terminated without Cause or resigns for Good Reason within two years following a Change of Control, he will be entitled to (a) any applicable prorated annual bonus for such year and any accrued but unpaid annual bonus for the immediately preceding year; (b) severance payments in an amount equal to 1.5 times the sum of (i) his highest base salary in effect during the 12 months immediately prior to his termination date plus (ii) the average annual bonus earned by him for the most recent two fiscal years ending prior to his termination date; and (c) coverage under health, dental, life, accident, disability and similar benefit plans offered to (and on the same terms as) the other executive officers for the 18 months following his termination date. In addition, any restricted stock, stock option or other equity compensation awards will immediately vest as of the date of the Change of Control. The definition of Change of Control in our employment agreements with each of Messrs. Castaneda and Gunter is the same as the definition of Change of Control in our employment agreement with Mr. Prim described above. Similarly, the initial public offering described in this prospectus is not an event that would trigger change of control payments under the employment agreements for Messrs. Castaneda and Gunter.

If either of Messrs. Castaneda or Gunter becomes subject to excise taxes under Section 4999 of the Internal Revenue Code, or any interest or penalty is incurred by any of them with respect to such excise taxes, then the payments owed under the applicable employment agreement will be reduced to avoid such taxes, interest or penalties if doing so will result in greater after tax payments to the executive.

The employment agreements also contain confidentiality provisions and non-competition and non-solicitation covenants prohibiting Messrs. Castaneda and Gunter from, among other things, competing with us or soliciting our customers, suppliers or employees for the 12-month period following the termination of their respective employment.

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Potential Payments Upon Termination or Change of Control

Arrangements in Effect Prior to this Offering

Until Messrs. Prim, Castaneda and Gunter entered into the new employment agreements discussed below in connection with this offering, no NEO was party to any change of control agreement or employment agreement that would provide benefits to that NEO upon his termination or upon a change of control of the Company. The NEOs are entitled to certain benefits payable by our insurance carrier under our current insurance policies in the case of a termination resulting from death or disability. Certain option award agreements with our NEOs provide for accelerated vesting upon a change of control.

The following table sets forth the amounts payable to Messrs. Prim, Castaneda, Gunter, Belmont and Boydston upon a Transfer of Control as defined in such NEO s option award agreement, assuming the Transfer of Control occurred on December 31, 2009. The relevant option award agreements define a Transfer of Control as: (i) the direct or indirect sale or exchange by the stockholders of the Company of all or substantially all of the stock of the Company where the stockholders of the Company before such sale or exchange do not retain, directly or indirectly, at least a majority of the beneficial interest in the voting stock of the Company after such sale or exchange; (ii) a merger in which the Company is not the surviving corporation; (iii) a merger in which the Company is the surviving corporation where the stockholders of the Company before such merger do not retain, directly or indirectly, at least a majority of the beneficial interest in the voting stock of the Company after such merger; (iv) the sale, exchange or transfer of all or substantially all of the Company assets (other than a sale, exchange or transfer to one or more subsidiary corporations of the Company); or (v) a liquidation or dissolution of the Company. The initial public offering described in this prospectus is not an event that would trigger change of control payments under the relevant option award agreements. As of December 31, 2009, no such NEO was entitled to any compensation or benefits in connection with his termination or upon a change of control other than as set forth below.

Name	Number of Shares Underlying Unvested Options Subject to Vesting Upon a Change of Control (#)	Amount Payable Upon a Change of Control ($)[1]
Billy D. Prim		
Mark Castaneda	112,500	
Michael S. Gunter		
Richard E. Belmont		
Brent C. Boydston		

(1) Represents the value of unvested stock options held at December 31, 2009, based upon the amount by which the fair market value on December 31, 2009 ($) of the shares of common stock underlying those options exceeded the $1.98 exercise price of such options. The fair market value on December 31, 2009 represents the midpoint range of the initial public offering price set forth on the cover page of this prospectus.

New Employment Agreements

In connection with this offering, we have entered into new employment agreements with each of Messrs. Prim, Castaneda and Gunter. Under these new agreements, these NEOs will be entitled to certain benefits upon their termination or upon a Change of Control (as defined in the employment agreement). A more detailed description of the terms of these employment agreements and the definitions of Change of Control, Cause and Good Reason are available under the section captioned Employment Agreements and Change of Control Arrangements above.

Unless any of Messrs. Prim, Castaneda or Gunter is terminated for Cause or resigns without Good Reason, he will be entitled to any applicable prorated annual bonus for that year and any accrued but unpaid annual bonus for the immediately preceding year.

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Under these new employment agreements, if any of Messrs. Prim, Castaneda or Gunter is terminated without Cause or if any of Messrs. Prim, Castaneda or Gunter resigns for Good Reason, then such individual will be entitled to the following benefits:

- severance payments in an amount equal to (i) his highest annual base salary in effect during the 12 months immediately prior to his termination date plus (ii) the average annual bonus earned by him for the most recent two fiscal years ending prior to his termination date;
- coverage under health, dental, life, accident, disability and similar benefit plans offered to (and on the same terms as) the other executive officers for the 12 months following his termination date; and
- the immediate vesting of any restricted stock, stock option or other equity compensation awards scheduled to vest within six months his termination date.

Under these new employment agreements, if any of Messrs. Prim, Castaneda or Gunter is terminated without Cause or if any such individual resigns for Good Reason within two years following a Change of Control, then he will be entitled to the following benefits under his employment agreement:

- severance payments in an amount equal to 1.5 times (two times in the case of Mr. Prim) the sum of (i) his highest annual base salary in effect during the 12 months immediately prior to his termination date plus (ii) the average annual bonus earned by him for the most recent two fiscal years ending prior to his termination date; and
- coverage under health, dental, life, accident, disability and similar benefit plans offered to (and on the same terms as) the other executive officers for the 18 months (24 months in the case of Mr. Prim) following his termination date.

In addition, any restricted stock, stock option or other equity compensation awards that are unvested will immediately vest as of the date of the Change of Control.

The following table sets forth the amounts payable to Messrs. Prim, Castaneda and, Gunter upon termination of employment or a Change in Control as defined in their employment agreements, assuming each of the events occurred on December 31, 2009 and assuming that the employment agreements that such individuals have entered into in connection with this offering were in effect as of December 31, 2009. As described in Arrangements in Effect Prior to this Offering, neither Mr. Belmont nor Mr. Boydston is entitled to any compensation or benefits in connection with his termination or upon Change of Control.

Benefits and Payments Upon Termination	Termination for Cause or Without Good Reason ($)	Termination Without Cause or for Good Reason ($)	Termination Without Cause or for Good Reason Following a Change of Control ($)	Termination Due to Disability ($)[1]	Termination Due to Death ($)[2]	Change of Control (No Termination) ($)[3]
Billy D. Prim:						

Base Salary[4]	400,000	800,000
Annual Cash Bonus		
Unvested Stock Options	[5]	[6]
Health Insurance[7]	5,500	11,000
Life Insurance[7]	204	408
Disability Coverage[7]	923	1,846
Total:		

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Benefits and Payments Upon Termination	Termination for Cause or Without Good Reason ($)	Termination Without Cause or for Good Reason ($)	Termination Without Cause or for Good Reason Following a Change of Control ($)	Termination Due to Disability ($)[1]	Termination Due to Death ($)[2]	Change of Control (No Termination) ($)[3]
Mark Castaneda:						
Base Salary[8]		250,000	375,000			
Annual Cash Bonus[9]		15,000	22,500			
Unvested Stock Options		[5]	[6]			
Health Insurance[10]		7,672	11,508			
Life Insurance[10]		204	306			
Disability Coverage[10]		923	1,385			
Total:						
Michael S. Gunter:						
Base Salary[8]		225,000	337,500			
Annual Cash Bonus[9]		26,703	40,055			
Unvested Stock Options		[5]	[6]			
Health Insurance[10]		7,672	11,508			
Life Insurance[10]		204	306			
Disability Coverage[10]		846	1,296			
Total:						

(1) Excludes amounts payable to the executive by our insurance carrier upon termination resulting from the disability of such executive under disability insurance policies maintained for the benefit of the executive.

(2) Excludes amounts payable to the executive by our insurance carrier upon termination resulting from the death of such executive under life insurance policies maintained for the benefit of the executive.

(3) Represents the value of unvested stock options subject to vesting in connection with a Change of Control (as defined in the executive s option award agreement) held at December 31, 2009, based upon the amount by which the fair market value on December 31, 2009 ($) of the shares of common stock underlying those options exceeded the exercise price of such options. The fair market value on December 31, 2009 represents the midpoint range of the initial public offering price set forth on the cover page of this prospectus.

(4) Represents a payment equal to Mr. Prim s highest base salary in effect during the 12 months immediately prior to the termination date in the case of a termination without Cause or for Good Reason and a payment equal to two times Mr. Prim s highest base salary in effect during the 12 months immediately prior to the termination date in the case of a termination without Cause or for Good Reason in connection with a Change of Control.

(5) Represents the value of unvested stock options held at December 31, 2009 which are scheduled to vest within six month of such date, based upon the amount by which the fair market value on December 31, 2009 ($) of the shares of common stock underlying those options exceeded the exercise price of such options. The fair market value on December 31, 2009 represents the midpoint range of the initial public offering price set forth on the cover page of this prospectus.

(6) Represents the value of all unvested stock options held at December 31, 2009, based upon the amount by which the fair market value on December 31, 2009 ($) of the shares of common stock underlying those options exceeded the exercise price of such options. The fair market value on December 31, 2009 represents the midpoint range of the initial public offering price set forth on the cover page of this prospectus.

(7) In the case of a termination without Cause or for Good Reason, represents the estimated incremental cost to maintain coverage under the applicable policy for 12 months. In the case of a termination without Cause or for Good Reason in connection with a Change of Control, represents the estimated incremental cost to us maintain coverage under the applicable policy for 24 months.

(8) Represents a payment equal to such executive s highest base salary in effect during the 12 months immediately prior to the termination date in the case of a termination without Cause or for Good Reason and a payment equal to 1.5 times such executive s highest base salary in effect during the 12 months immediately prior to the termination date in the case of a termination without Cause or for Good Reason in connection with a Change of Control.

(9) Represents a payment equal to the average annual bonus earned by the executive for the most recent two fiscal years ending prior to the termination date in the case of a termination without Cause or for Good Reason and a payment equal to 1.5 times the average annual bonus earned by the executive for the most recent two fiscal years ending prior to the termination date in the case of a termination without Cause or for Good Reason in connection with a Change of Control.

(10) In the case of a termination without Cause or for Good Reason, represents the estimated incremental cost to maintain coverage under the applicable policy for 12 months. In the case of a termination without Cause or for Good Reason in connection with a Change of Control, represents the estimated incremental cost to us maintain coverage under the applicable policy for 18 months.

Equity and Stock Option Plans

2010 Omnibus Long-Term Incentive Plan

In March 2010 our Board of Directors adopted and in April 2010 our stockholders approved the Primo Water Corporation 2010 Omnibus Long-Term Incentive Plan, which we refer to as the 2010 Omnibus Plan and which will be effective prior to the closing of this offering. The material terms of the 2010 Omnibus Plan are summarized below.

Administration of the Plan. Our Board of Directors has such powers and authorities related to the administration of the 2010 Omnibus Plan as are consistent with our corporate governance documents and applicable law. The Board of Directors may (and in some cases under applicable law, our governance documents or regulatory requirements, must) delegate to a committee (the committee) administration of all or some parts of the 2010 Omnibus Plan. Following the initial public offering and to the extent required by applicable law, the committee or a sub-committee, as applicable, to which administrative responsibility will be delegated will be comprised of directors who (i) qualify as outside directors within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended (the Code), (ii) meet such other requirements as may be established from time to time by the SEC for plans intended to qualify for exemption under Rule 16b-3 (or its successor) under the Securities Exchange Act of 1934, as amended, and (iii) comply with the independence requirements of the stock exchange on which our common stock is listed.

Number of Authorized Shares. The initial number of shares of our common stock reserved for issuance under the 2010 Omnibus Plan is 7,500,000. In addition, any shares of our stock which are subject to stock options granted under the 2004 Stock Plan and are canceled, expired, forfeited, settled in cash or otherwise terminated without delivery of shares, will be available for issuance under the 2010 Omnibus Plan. Subject to the terms of the 2010 Omnibus Plan, 7,500,000 of the reserved shares may be issued pursuant to incentive stock options (ISOs). Following the end of the Transition Period (as defined herein) and subject to adjustment as described below, the maximum number of each type of award granted to any grantee in any 36-month period and intended to constitute performance-based compensation under Section 162(m) will not exceed the following:

options 1,000,000;

stock appreciation rights 1,000,000;

restricted stock 1,000,000;

restricted stock units 1,000,000; and

other stock-based performance awards 1,000,000.

Any shares covered by an award that are forfeited, expired, cancelled, settled in cash, settled by issuance of fewer shares than the amount underlying the award, or otherwise terminated without delivery of shares to the grantee, will be available for future grants under the 2010 Omnibus Plan. The number and class of shares available under the 2010 Omnibus Plan and/or subject to outstanding awards may be equitably adjusted by our Board of Directors in the event of various changes in the capitalization of the Company.

Eligibility and Participation. Eligibility to participate in the 2010 Omnibus Plan is limited to such employees, officers, non-employee directors, consultants and advisors of the Company, or of any affiliate, as our Board of Directors may determine and designate from time to time.

Type of Awards. The following types of awards are available for grant under the 2010 Omnibus Plan: ISOs, non-qualified stock options (NSOs), stock appreciation rights (SARs), restricted stock, restricted stock units, cash- or stock-based performance awards and other stock-based awards.

Stock Options and SARs

Grant of Options and SARs. Our Board of Directors may award ISOs, NSOs (together, Options), and SARs to grantees. Our Board of Directors is authorized to grant SARs either in tandem with or as a component of other awards or alone.

Exercise Price of Options and SARs. The exercise price per share of an Option will be at least 100% of the fair market value per share of our stock underlying the award on the grant date and in no case will the exercise price of any Option be less than the par value of a share of our stock. A SAR will confer on the grantee a right to receive, upon exercise, a payment of the excess of (i) the fair market value of one share of our stock on the date of exercise over (ii) the grant price of the SAR as determined by our Board of Directors. The grant price will be fixed at the fair market value of a share of stock on the date of grant. SARs granted in tandem with an outstanding Option following the grant date of such Option will have a grant price that is equal to the Option s exercise price; provided, however, that the SAR s grant price may not be less than the fair market value of a share of stock on the grant date of the SAR.

Vesting of Options and SARs. Our Board of Directors will determine the terms and conditions (including any performance requirements) under which an Option or SAR will become exercisable and will include such information in the award agreement.

Special Limitations on ISOs. In the case of a grant of an Option intended to qualify as an ISO to a grantee that owns more than ten percent of the total combined voting power of all classes of our outstanding stock (a Ten Percent Stockholder), the exercise price of the Option will not be less than 110% of the fair market value of a share of our stock on the grant date. Additionally, an Option will constitute an ISO only (i) if the grantee is an employee of the Company or a subsidiary of the Company, (ii) to the extent such Option is specifically designated as an ISO in the related award agreement, and (iii) to the extent that the aggregate fair market value (determined at the time the option is granted) of the shares of stock with respect to which all ISOs held by such grantee become exercisable for the first time during any calendar year (under the 2010 Omnibus Plan and all other plans of the grantee s employer and its affiliates) does not exceed $100,000.

Exercise of Options and SARs. An Option may be exercised by the delivery to us of written notice of exercise and payment in full of the exercise price (plus the amount of any taxes which we may be required to withhold). The minimum number of shares with respect to which an Option may be exercised, in whole or in part, at any time will be the lesser of (i) the number set forth in the applicable award agreement and (ii) the maximum number of shares available for purchase under the Option at the time of exercise. Our Board of Directors has the discretion to determine the method or methods by which a SAR may be exercised.

Expiration of Options and SARs. Options and SARs will expire at such time as our Board of Directors determines; provided, however, that no Option may be exercised more than ten years from the date of grant, or in the case of an ISO held by a Ten Percent Stockholder, not more than five years from the date of grant.

Restricted Stock and Restricted Stock Units

Restricted Stock. At the time a grant of restricted stock is made, our Board of Directors may, in its sole discretion, establish the applicable restricted period and prescribe restrictions in addition to or other than the expiration of the restricted period, including the satisfaction of corporate or individual performance objectives. Unless our Board of Directors otherwise provides in an award agreement, holders of restricted stock will have the right to vote such stock and the right to receive any dividends declared or paid with respect to such stock. Our Board of Directors may provide that any such dividends paid must be reinvested in shares of stock, which may or may not be subject to the same vesting conditions and restrictions applicable to such restricted stock. All distributions, if any, received by a grantee

with respect to restricted stock as a result of any stock split, stock dividend, combination of shares, or other similar transaction will be subject to the restrictions applicable to the original grant.

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The grantee will be required, to the extent required by applicable law, to purchase the restricted stock at a price equal to the greater of (i) the aggregate par value of the shares of stock represented by such restricted stock or (ii) the price, if any, specified in the award agreement relating to such restricted stock. If specified in the award agreement, the price may be deemed paid by services already rendered.

Restricted Stock Units. At the time a grant of restricted stock units is made, our Board of Directors may, in its sole discretion, establish the applicable restricted period and prescribe restrictions in addition to or other than the expiration of the restricted period, including the satisfaction of corporate or individual performance objectives. Holders of restricted stock units will have no rights as stockholders of the Company. Our Board of Directors may provide that the holder of restricted stock units will be entitled to receive dividend equivalent rights, which may be deemed reinvested in additional restricted stock units.

Cash- and Stock-Based Performance Awards

The right of a grantee to exercise or receive a grant or settlement of any award, and the timing thereof, may be subject to such performance conditions as may be specified by our Board of Directors. Our Board of Directors may use such business criteria and other measures of performance as it may deem appropriate in establishing any performance conditions, and may, subject to certain limitations in the case of a performance award intended to qualify under Section 162(m) of the Code (Section 162(m)), exercise its discretion to reduce the amounts payable under any award subject to performance conditions.

Following the completion of the Transition Period (as defined herein), we intend that performance awards granted to persons who are designated by our Board of Directors as likely to be Covered Employees within the meaning of Section 162(m) and regulations thereunder will, if so designated by our Board of Directors, constitute qualified performance-based compensation within the meaning of Section 162(m) and regulations thereunder. The grant, exercise and/or settlement of such performance awards will be contingent upon achievement of pre-established performance goals which will consist of one or more business criteria and a targeted level or levels of performance with respect to each of such criterion. Performance goals will be objective and will otherwise meet the requirements of Section 162(m) and regulations thereunder. In addition, after the Transition Period, the maximum amount of each cash-based performance award intended to constitute performance-based compensation under Section 162(m) granted to a grantee in any 12-month period will not exceed $2,000,000.

One or more of the following business criteria for the Company will be used exclusively by our Board of Directors in establishing performance goals for such awards: net sales; revenue; revenue growth or product revenue growth; operating income (before or after taxes); pre-or after-tax income (before or after allocation of corporate overhead and bonuses); net earnings; earnings per share; net income (before or after taxes); return on equity; total stockholder return; return on assets or net assets; appreciation in and/or maintenance of, share price; market share; gross profits; earnings (including earnings before taxes, earnings before interest and taxes or earnings before interest, taxes depreciation and amortization); economic value-added models or equivalent metrics; comparisons with various stock market indices; reduction in costs; cash flows or cash flows per share (before or after dividends); return on capital (including return on total capital or return on invested capital); cash flow return on investment; improvement in or attainment of expense levels or working capital levels; operating margins; gross margins or cash margin; year-end cash; debt reductions; stockholder equity; regulatory performance; implementation, completion or attainment of measurable objectives with respect to research, development, products or projects and recruiting and maintaining personnel; and, prior to the completion of the Transition Period (as defined herein), to the extent permitted by applicable law, any other business criteria as determined by our Board of Directors.

Other Stock-Based Awards

Our Board of Directors may, in its discretion, grant other stock-based awards, consisting of stock units or other awards, valued in whole or in part by reference to, or otherwise based upon, our common stock. The terms of such other stock-based awards will be set forth in the applicable award agreements.

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Effect of Certain Transactions. Except as otherwise provided in an award agreement, in the event of (a) the liquidation or dissolution of the Company or (b) a reorganization, merger, exchange or consolidation of the Company or involving the shares of our common stock (a Transaction), the 2010 Omnibus Plan and the awards issued pursuant to the plan shall continue in effect in accordance with their respective terms, except that following a Transaction either (i) each outstanding award will be treated as provided for in the agreement entered into in connection with the Transaction or (ii) if not so provided in such agreement, each grantee will be entitled to receive in respect of each share of our common stock subject to any outstanding awards, upon exercise or payment or transfer in respect of any award, the same number and kind of stock, securities, cash, property or other consideration that each holder of a share of our common stock was entitled to receive in the Transaction in respect of a share of common stock; provided, however, that, unless otherwise determined by our Board of Directors, such stock, securities, cash, property or other consideration shall remain subject to all of the conditions, restrictions and performance criteria which were applicable to the awards prior to such Transaction. Without limiting the generality of the foregoing, the treatment of outstanding Options and SARS in connection with a Transaction in which the consideration paid or distributed to our stockholders is not entirely shares of common stock of the acquiring or resulting corporation may include the cancellation of outstanding Options and SARS upon consummation of the Transaction as long as, at the election of our Board of Directors, (x) the holders of affected Options and SARs have been given a period of at least fifteen days prior to the date of the consummation of the Transaction to exercise the Options or SARs (whether or not they were otherwise exercisable) or (y) the holders of the affected Options and SARs are paid (in cash or cash equivalents) in respect of each share covered by the Option or SAR being canceled an amount equal to the excess, if any, of the per share price paid or distributed to our stockholders in the Transaction (the value of any non-cash consideration to be determined by our Board of Directors in its sole discretion) over the Option or SAR exercise price, as applicable. For avoidance of doubt, (1) the cancellation of Options and SARs as described in the preceding sentence may be effected notwithstanding anything to the contrary contained in the 2010 Omnibus Plan or any award agreement and (2) if the amount determined pursuant to the preceding sentence is zero or less, the affected Option or SAR may be cancelled without any payment therefor.

Change in Control. Our Board of Directors will determine the effect of a change in control (as defined in the 2010 Omnibus Plan) of the Company with respect to any Award or Awards, including but not limited to, acceleration of vesting, termination or assumption of Awards.

Deferral Arrangements. Our Board of Directors may permit or require the deferral of any award payment into a deferred compensation arrangement.

Nontransferability of Awards. Generally, during the lifetime of a grantee, only the grantee may exercise rights under the 2010 Omnibus Plan and no award will be assignable or transferable other than by will or laws of descent and distribution. If authorized in the award agreement, a grantee may transfer, not for value, all or part of an award (other than an ISO) to certain family members (including trusts and foundations for the benefit thereof). Neither restricted stock nor restricted stock units may be sold, transferred, assigned, pledged or otherwise encumbered or disposed of during the restricted period or prior to the satisfaction of any other restrictions prescribed by our Board of Directors.

Separation from Service. Our Board of Directors may provide in the applicable award agreements for actions that will be taken upon a grantee s separation from service from the Company, including but not limited to, accelerated vesting or termination of awards.

Tax Withholding and Tax Offset Payments. We will have the right to deduct from payments of any kind otherwise due to a grantee any federal, state, or local taxes of any kind required by law to be withheld with respect to the vesting of or other lapse of restrictions applicable to an award or upon the issuance of any shares of stock upon the exercise of an Option or pursuant to an award.

Term of Plan. Unless earlier terminated by our Board of Directors, the authority to make grants under the 2010 Omnibus Plan will terminate on the date that is ten years after it is adopted by our Board of Directors.

Amendment and Termination. Our Board of Directors may, at any time and from time to time, amend, suspend, or terminate the 2010 Omnibus Plan as to any shares of stock as to which awards have not been made. An amendment will be contingent on approval of our stockholders to the extent stated by our Board of Directors, required by applicable law or required by applicable stock exchange listing requirements. No awards will be made after termination of the 2010 Omnibus Plan. No amendment, suspension, or termination of the 2010 Omnibus Plan will, without the consent of the grantee, impair rights or obligations under any award theretofore awarded under the 2010 Omnibus Plan.

New Plan Benefits. All grants of awards under the 2010 Omnibus Plan will be discretionary. Therefore, in general, the benefits and amounts that will be received under the 2010 Omnibus Plan are not determinable.

Federal Income Tax Consequences. The following is a summary of the general federal income tax consequences to the Company and to U.S. taxpayers of awards granted under the 2010 Omnibus Plan. Tax consequences for any particular individual or under state or non-U.S. tax laws may be different.

NSOs and SARs. No taxable income is reportable when a NSO or SAR is granted. Upon exercise, generally, the recipient will have ordinary income equal to the fair market value of the underlying shares of stock on the exercise date minus the exercise price. Any gain or loss upon the disposition of the stock received upon exercise will be capital gain or loss to the recipient if the appropriate holding period under federal tax law is met for such treatment.

ISOs. No taxable income is reportable when an ISO is granted or exercised (except for grantees who are subject to the alternative minimum tax, who may be required to recognize income in the year in which the ISO is exercised). If the recipient exercises the ISO and then sells the underlying shares of stock more than two years after the grant date and more than one year after the exercise date, the excess of the sale price over the exercise price will be taxed as long-term capital gain or loss. If the recipient exercises the ISO and sells the shares before the end of the two- or one-year holding periods, he or she generally will have ordinary income at the time of the sale equal to the fair market value of the shares on the exercise date (or the sale price, if less) minus the exercise price of the ISO.

Restricted Stock and Restricted Stock Units. A recipient of restricted stock or restricted stock units will not have taxable income upon the grant unless, in the case of restricted stock, he or she elects to be taxed at that time. Instead, he or she will have ordinary income at the time of vesting equal to the fair market value on the vesting date of the shares (or cash) received minus any amount paid for the shares.

Cash- and Stock-Based Performance Awards and Other Stock-Based Awards. Typically, a recipient will not have taxable income upon the grant of cash or stock-based performance awards or other stock-based awards. Subsequently, when the conditions and requirements for the grants have been satisfied and the payment determined, any cash received and the fair market value of any common stock received will constitute ordinary income to the recipient.

Tax Effect for the Company. We generally will receive a tax deduction for any ordinary income recognized by a grantee in respect of an award under the 2010 Omnibus Plan (for example, upon the exercise of a NSO). In the case of ISOs that meet the holding period requirements described above, the grantee will not recognize ordinary income; therefore, we will not receive a deduction.

Once we become a public company, special rules limit the deductibility of compensation paid to our CEO and to each of our three most highly compensated executive officers whose compensation is required to be reported annually in our proxy. Under Section 162(m), the annual compensation paid to each of these executives may not be deductible to the extent that it exceeds $1 million. However, we intend to rely on Treas. Reg. Section 1.162-27(f) which provides that the deduction limit of Section 162(m) does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the company was not publicly held. Subject to certain requirements,

we may rely on this grandfather provision until the first meeting of stockholders

at which directors are elected that occurs after the end of the third calendar year following the calendar year in which the offering occurs (the Transition Period). Additionally, after the expiration of the grandfather period, we can preserve the deductibility of compensation over $1 million if certain conditions of Section 162(m) are met. These conditions include stockholder approval of the 2010 Omnibus Plan, setting limits on the number of awards that any individual may receive and, for awards other than Options and SARs, establishing performance criteria that must be met before the award will actually be granted, be settled, vest or be paid. The 2010 Omnibus Plan has been designed to permit our Board of Directors to grant awards that qualify as performance-based for purposes of satisfying the conditions of Section 162(m).

Registration of Shares. Following the closing of this offering we intend to file a registration statement on Form S-8 under the Securities Act to register the full number of shares of our common stock which will be reserved for issuance under the 2010 Omnibus Plan, as described in the section titled *Number of Authorized Shares* above (plus such number of shares reserved under the 2004 Stock Plan that become available for issuance under the 2010 Omnibus Plan), as well as registration statements on Form S-8 to register shares of common stock reserved for issuance under the 2004 Stock Plan.

2004 Stock Plan

On November 1, 2004, our Board of Directors adopted the Primo Water Corporation 2004 Stock Plan, which we refer to as the 2004 Stock Plan. The material terms of the 2004 Stock Plan are summarized below.

Administration of the Plan. Our Board of Directors has such powers and authorities related to the administration of the 2004 Stock Plan as are consistent with our corporate governance documents and applicable law and may delegate to a committee administration of all or some parts of the 2004 Stock Plan. Our Board of Directors has the authority to, among other things, interpret the plan, terminate or amend the plan, determine individuals eligible to participate in the plan and determine the size and terms of awards granted under the plan.

Number of Authorized Shares. A total of 4,500,000 shares of our common stock are reserved for issuance under the 2004 Stock Plan. As of May 1, 2010, options to purchase a total of 3,200,087 shares of our common stock with a weighted average exercise price of $1.26 were outstanding under our 2004 Stock Plan. In addition, 1,102,500 shares of restricted stock have been issued pursuant to the 2004 Stock Plan. We do not intend to issue any additional awards under the 2004 Stock Plan following the closing of this offering. All awards outstanding under the 2004 Stock Plan will remain in effect and will continue to be governed by their existing terms.

Eligibility and Participation. Eligibility to participate in the 2004 Stock Plan is limited to such key employees, non-employee directors and consultants of the Company, or of any parent or subsidiary, as our Board of Directors may determine and designate from time to time.

Types of Awards. The following types of awards are available for grant under the 2004 Stock Plan: incentive stock options (ISOs), non-qualified stock options (NSOs , and together with ISOs, Options) and rights to purchase restricted shares of our common stock (Purchase Rights).

Stock Options

Grant of Options. Our Board of Directors may award ISO and NSOs to grantees under the 2004 Stock Plan. The exercise price per share of an Option is determined by our Board of Directors; provided, however, in no event will the exercise price of an ISO be less than 100% of the fair market value per share of our stock underlying the award on the grant date. In the case of a grant of an Option intended to qualify as an ISO to a grantee that owns more than ten percent of the total combined voting power of all classes of our outstanding stock, the exercise price of the Option will

not be less than 110% of the fair market value of a share of our stock on the grant date. Additionally, an Option will constitute an ISO only (i) if the grantee is an employee of the Company or a subsidiary of the Company, (ii) to the extent specifically provided in the related award agreement, and (iii) to the extent that the aggregate fair market value (determined at the time the option is granted) of the

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shares of stock with respect to which all ISOs held by such grantee become exercisable for the first time during any calendar year (under the 2004 Stock Plan and all other plans of the grantee s employer and its affiliates) does not exceed $100,000.

Stock Option Vesting and Exercise. Our Board of Directors will determine the vesting terms of all Options and will include such information in the award agreement. An Option may be exercised by the delivery to us of written notice of exercise and payment in full of the exercise price (plus the amount of any taxes which we may be required to withhold). The exercise price may be paid in cash or, at the discretion of our Board of Directors, in shares of the Company s stock having a fair market value equal to the exercise price or by a combination of cash and stock. Once vested, Options granted under the 2004 Stock Plan remain exercisable for the term of the Option, which may not exceed ten years, provided that the Options may terminate prior to the end of the term if the grantee s service relationship with us terminates. On April 29, 2010, our Board of Directors determined that all outstanding unvested Options granted under the 2004 Stock Plan will accelerate and be fully vested upon the closing of the initial public offering described in this prospectus. This accelerated vesting will result in a non-cash charge of approximately $300,000.

Transferability of Options. A grantee of an Option under the 2004 Stock Plan may not transfer such Option except by will or the laws of descent or distribution.

Stock Purchase Rights

Our Board of Directors may award Purchase Rights evidenced by restricted stock agreements and/or subscription agreements under the 2004 Stock Plan. Our Board of Directors will determine the number of shares subject to the Purchase Right and the purchase price for each share to be purchased pursuant to the Purchase Right and set forth this information in the grantee s award agreement. Our Board of Directors will also determine any transfer restrictions on shares purchased pursuant to a Purchase Right and may, in their sole discretion, provide for a right of the Company to repurchase any shares purchased pursuant to a Purchase Right in the grantee s award agreement. Upon the exercise of a Purchase Right, the grantee will possess all rights of a stockholder of the Company.

Change in Control. The 2004 Stock Plan does not specify any particular effect of a change in control of the Company on awards granted under the 2004 Stock Plan. A majority of the Option awards currently outstanding under the 2004 Stock Plan will be deemed 100% vested and exercisable upon a Transfer of Control (as defined in the Option award agreements) of the Company. This offering will not qualify as a Transfer of Control for purposes of the Option award agreements under the 2004 Stock Plan.

Corporate Event. In the event of a merger or consolidation of the Company, a sale of all or substantially all of our assets or a dissolution or liquidation of the Company, our Board of Directors may make such adjustments to the awards granted under the 2004 Stock Plan as it deems appropriate and equitable to prevent substantial dilution or enlargement of the rights granted under the 2004 Stock Plan.

Term of Plan. Unless earlier terminated by our Board of Directors, the authority to make grants under the 2004 Stock Plan will terminate on October 31, 2014. However, we do not intend to issue any additional awards under the 2004 Stock Plan following the closing of this offering.

Federal Income Tax Consequences. The following is a summary of the general federal income tax consequences to the Company and to U.S. taxpayers of awards granted under the 2004 Stock Plan. Tax consequences for any particular individual or under state or non-U.S. tax laws may be different.

NSOs. No taxable income is reportable when a NSO is granted. Upon exercise, generally, the recipient will have ordinary income equal to the fair market value of the underlying shares of stock on the exercise date minus the exercise price. Any gain or loss upon the disposition of the stock received upon exercise will be capital gain or loss to the recipient if the appropriate holding period under federal tax law is met for such treatment.

ISOs. No taxable income is reportable when an ISO is granted or exercised (except for grantees who are subject to the alternative minimum tax, who may be required to recognize income in the year in which the ISO is exercised). If the recipient exercises the ISO and then sells the underlying shares of stock more than two years after the grant date and more than one year after the exercise date, the excess of the sale price over the exercise price will be taxed as long-term capital gain or loss. If the recipient exercises the ISO and sells the shares before the end of the two- or one-year holding periods, he or she generally will have ordinary income at the time of the sale equal to the fair market value of the shares on the exercise date (or the sale price, if less) minus the exercise price of the ISO.

Purchase Rights. A recipient of a Purchase Right will recognize ordinary income on the later of the date the Purchase Right is exercised and the date any applicable vesting conditions with respect to the Purchase Rights have been met. The amount of taxable income recognized by the recipient will be the difference between the fair market value of the stock on the exercise or vesting date, as applicable, and the purchase price paid for the shares.

Tax Effect for the Company. We generally will receive a tax deduction for any ordinary income recognized by a grantee in respect of an award under the 2004 Stock Plan (for example, upon the exercise of a NSO). In the case of ISOs that meet the holding period requirements described above, the grantee will not recognize ordinary income; therefore, we will not receive a deduction.

Once we become a public company, special rules limit the deductibility of compensation paid to our CEO and to each of our three most highly compensated executive officers (other than our Chief Financial Officer) whose compensation is required to be reported annually in our proxy. Under Section 162(m), the annual compensation paid to each of these executives may not be deductible to the extent that it exceeds $1 million. However, we intend to rely on Treas. Reg. Section 1.162-27(f) which provides that the deduction limit of Section 162(m) does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the company was not publicly held. Subject to certain requirements, we may rely on this grandfather provision until the first meeting of stockholders at which directors are elected that occurs after the end of the third calendar year following the calendar year in which the offering occurs (the Transition Period). Additionally, after the expiration of the grandfather period, we can preserve the deductibility of compensation over $1 million if certain conditions of Section 162(m) are met. These conditions include stockholder approval of the 2004 Stock Plan, setting limits on the number of awards that any individual may receive and, for awards other than Options, establishing performance criteria that must be met before the award will actually be granted, be settled, vest or be paid.

Registration of Shares. Following the closing of this offering we intend to file a registration statement on Form S-8 under the Securities Act to register the shares of common stock reserved for issuance pursuant to outstanding awards under the 2004 Stock Plan.

2010 Employee Stock Purchase Plan

In March 2010 our Board of Directors adopted and in April 2010 our stockholders approved the 2010 Employee Stock Purchase Plan, or the ESPP, which will be effective upon the consummation of this offering. Our ESPP is intended to qualify as an employee stock purchase plan as defined under Section 423 of the Code and will become effective on the day preceding the consummation of this offering.

Administration of the ESPP. The compensation committee of our Board has authority to interpret and implement the terms of the ESPP. The committee will have the discretion to set the terms of each offering in accordance with the provisions of the ESPP, to make all determinations regarding the ESPP, including eligibility, and otherwise administer the ESPP.

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Number of Authorized Shares. A total of 250,000 shares of our common stock will be made available for sale under our ESPP, subject to adjustment in the event of any significant change in our capitalization, such as a stock split, a combination or exchange or shares, or a stock dividend or other distribution.

Eligibility and Participation. All of our employees generally are eligible to participate if they are customarily employed by us or any participating subsidiary for at least 20 hours per week and more than five months in any calendar year. The committee may exclude from an offering period highly-compensated employees or employees who have not satisfied a minimum period of employment with us which may not exceed a period of two years. In addition, an employee may not be granted rights to purchase stock under our ESPP if such employee would:

- immediately after any grant of purchase rights, own stock possessing 5% or more of the total combined voting power or value of all classes of our capital stock; or

- hold rights to purchase stock under all of our employee stock purchase plans that would accrue at a rate that exceeds $25,000 worth of our stock for each calendar year.

Offer Periods and Purchase Periods. The ESPP provides for offering periods of up to 27 months. The initial offering period under the ESPP will begin on the effective date of this offering and will end on December 31, 2010. Subsequent offerings are expected to consist of 12-month offering periods, with a new offering period beginning every January 1 and separate purchases taking place every 6 months during each offering period. However, we may change the timing and duration of offering periods and the frequency of purchases, as long as such changes comply with the terms of the ESPP. Unless otherwise specified by the committee, a participant may purchase a maximum of 50,000 shares of common stock during an offering period. No grant of purchase rights will be made under the ESPP prior to the consummation of this offering.

Payroll Deductions. Our ESPP permits participants to exercise their stock purchase rights under the ESPP through payroll deductions of up to 15% of their eligible compensation, which includes a participant s gross base compensation from the Company, excluding overtime payments, sales commissions, incentive compensation, bonuses, expense reimbursements, fringe benefits and other special payments.

Exercise of Purchase Rights. Amounts deducted and accumulated by the participant are used to purchase shares of our common stock at the end of each purchase period during an offering period. The purchase price of the shares will not be less than 85% of the fair market value of our common stock on the first trading day of the offering period or on the last day of the applicable purchase period, whichever is lower. Participants may withdraw from participation in the ESPP at any time during an offering period, and will be paid their accrued payroll deductions that have not yet been used to purchase shares of common stock. Participation ends automatically upon termination of employment with us.

Change in Control. In the event of a Change in Control (as defined in the ESPP), the committee may provide for the successor corporation to assume or substitute each outstanding purchase right, cashout of the participant s purchase right, acceleration of the next purchase date or termination of the current offering period without a purchase.

Amendment and Termination. The ESPP will automatically terminate in 2020, unless we terminate it sooner. In addition, our Board of Directors has the authority to amend, suspend or terminate our ESPP, except that, subject to certain exceptions described in the ESPP, no such action may adversely affect any outstanding rights to purchase stock under our ESPP.

Registration of Shares. Following the completion of this offering we intend to file a registration statement on Form S-8 under the Securities Act to register the full number of shares of our common stock which will be reserved for issuance under the ESPP, as described in the section titled *Number of Authorized Shares* above.

PRINCIPAL STOCKHOLDERS

The following table sets forth certain information regarding the beneficial ownership of our common stock as of May 1, 2010, and as adjusted to reflect the sale of our common stock offered by this prospectus and the issuance of shares of common stock to Culligan to fund a portion of the purchase price for the Culligan Refill Acquisition (assuming an initial public offering price of $ per share, the midpoint of the range set forth on the cover page of this prospectus), by:

- each of our named executive officers;
- each of our directors;
- all of our directors and current executive officers as a group; and
- each person (or group of affiliated persons) known to us to be the beneficial owner of more than 5% of our common stock.

Beneficial ownership is determined in accordance with the rules of the SEC and includes any shares over which a person exercises sole or shared voting or investment power. Under these rules, beneficial ownership also includes any shares as to which the individual or entity has the right to acquire beneficial ownership of within 60 days of May 1, 2010 through the exercise of any warrant, stock option or other right. Except as noted by footnote, and subject to community property laws where applicable, we believe that the stockholders named in the table below have sole voting and investment power with respect to all shares of common stock shown as beneficially owned by them.

Beneficial ownership is based upon shares of common stock outstanding as of May 1, 2010, and assumes (i) a -for- reverse stock split of our common stock that will occur immediately prior to the closing of this offering, (ii) the conversion of all of our issued and outstanding Series A and Series C convertible preferred stock into shares of common stock, (iii) the conversion of 50% of our issued and outstanding shares of Series B preferred stock into shares of common stock at a ratio of : , which is calculated by dividing the liquidation preference of the Series B preferred stock by 90% of an assumed initial public offering price of $ per share, which is the midpoint of the range set forth on the cover page of this prospectus, (iv) the redemption of the remaining 50% of our issued and outstanding shares of Series B preferred stock and the payment of accrued and unpaid dividends on all outstanding shares of Series B preferred stock and (v) our issuance of shares of our common stock with a value of $45.0 million (or shares assuming our initial public offering price of $ per share, which is the midpoint of the range set forth on the cover page of this prospectus), all effective as of May 1, 2010.

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Except as set forth below, the address of all stockholders listed under Directors and named executive officers and 5% or greater stockholders is c/o 104 Cambridge Plaza Drive, Winston-Salem, North Carolina 27104.

	Number of Shares		Percentage Ownership		
	Assuming No Exercise of Over-Allotment Option (#)	Assuming Full Exercise of Over-Allotment Option (#)	Prior to Offering (%)	After Offering (Assuming No Exercise of Over-Allotment Option) (%)	After Offering (Assuming Full Exercise of Over-Allotment Option) (%)
Directors and named executive officers					
Billy D. Prim[(1)]					
Richard A. Brenner[(2)]					
David W. Dupree[(3)]					