ACR GROUP INC
Form 10-Q
October 15, 2001

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

FORM 10-Q

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

For the quarterly period ended August 31, 2001

OR

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

For the transition period from ______________________ to ________________________
Commission file number 0-12490

ACR GROUP, INC.
(Exact name of registrant as specified in its charter)

Texas	74-2008473
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3200 Wilcrest Drive, Suite 440, Houston, Texas	77042-6039
(Address of principal executive offices)	(Zip Code)

(713) 780-8532
(Registrant's telephone number, including area code)

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

Shares of Common Stock outstanding at September 30, 2001 - 10,681,294.

PART I - FINANCIAL INFORMATION

Item 1. - Financial Statements

ACR GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS

	August 31, 2001 (Unaudited)	February 28, 2001
Current assets:		
Cash	$ 267,446	$ 171,249
Accounts receivable, net	21,537,122	15,975,668
Inventory	25,302,661	23,833,400
Prepaid expenses and other	275,425	642,912
Deferred income taxes	487,000	487,000
Total current assets	47,869,654	41,110,229
Property and equipment, net of accumulated depreciation	5,676,189	5,768,093
Deferred income taxes	773,000	973,000
Goodwill, net of accumulated amortization	6,108,500	6,222,895
Other assets	466,831	507,350
	$ 60,894,174	$ 54,581,567

LIABILITIES AND SHAREHOLDERS' EQUITY

	August 31, 2001 (Unaudited)	February 28, 2001
Current liabilities:		
Current maturities of long-term debt and capital lease obligations	$ 936,567	$ 956,201
Note payable - revolving line of credit	22,198,428	-
Accounts payable	21,345,850	17,146,529
Accrued expenses and other liabilities	2,376,336	1,837,638
Total current liabilities	46,857,181	19,940,368
Long-term debt and capital lease obligations, less current maturities	2,449,856	24,494,007
Total liabilities	49,307,037	44,434,375
Shareholders' equity:		
Common stock	106,813	106,813
Additional paid-in capital	41,691,379	41,691,379
Accumulated deficit	(30,211,055)	(31,651,000)
Total shareholders' equity	11,587,137	10,147,192
	$ 60,894,174	$ 54,581,567

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

ACR GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Six months ended August 31,		Three months ende August 31,	
	2001	2000	2001	2
Sales	$86,218,393	$ 73,387,722	$ 46,509,374	$40,
Cost of sales	67,696,585	57,639,142	36,589,058	31,
Gross profit	18,521,808	15,748,580	9,920,316	8,
Selling, general and administrative expenses	(15,789,614)	(13,610,563)	(8,163,757)	(7,
Other operating income (expense)	(1,049)	43,121	(1)	
Operating income	2,731,145	2,181,138	1,756,558	1,
Interest expense	(1,182,563)	(1,151,117)	(549,076)	(
Other non-operating income	230,497	175,855	140,394	
Income before income taxes	1,779,079	1,205,876	1,347,876	
Provision for income taxes:				
Current	139,134	119,280	103,534	
Deferred	200,000	-	200,000	
Net income	$ 1,439,945	$ 1,086,596	$ 1,044,342	$
Weighted average shares outstanding:				
Basic	10,681,294	10,671,103	10,681,294	10,
Diluted	10,692,047	11,290,980	10,702,800	11,
Earnings per common share:				
Basic	$ .13	$ .10	$ .10	$
Diluted	.13	.10	.10	

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

ACR GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

Six months ended

	August 31, 2001	August 31, 2000
Operating activities:		
Net income	$ 1,439,945	$ 1,086,596
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	710,463	592,707
Deferred income tax expense	200,000	-
Other	(10,255)	4,182
Changes in operating assets and liabilities:		
Accounts receivables	(5,532,651)	(4,480,428)
Inventory	(1,469,261)	(3,262,612)
Prepaid expenses and other assets	289,865	(498,110)
Accounts payable	4,264,255	6,782,644
Accrued expenses and other liabilities	538,698	465,808
Net cash provided by operating activities	431,059	690,787
Investing activities:		
Acquisition of property and equipment	(480,005)	(1,447,413)
Acquisition of business, net of cash acquired	-	(200,643)
Proceeds from disposition of assets	10,500	7,700
Net cash used in investing activities	(469,505)	(1,640,356)
Financing activities:		
Net borrowings on revolving credit facility	713,027	1,950,637
Payments on long-term debt	(578,384)	(978,650)
Net cash provided by financing activities	134,643	971,987
Net increase in cash	96,197	22,418
Cash at beginning of year	171,249	107,035
Cash at end of period	$ 267,446	$ 129,453
Schedule of non-cash investing and financing activities:		
Acquisition of subsidiaries:		
Fair value of assets acquired	-	793,712
Fair value of liabilities assumed	-	817,915
Goodwill	-	404,203
Notes payable to sellers	-	152,000
Purchase of property and equipment under capital leases and notes (net of cash)	-	968,612

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

ACR GROUP, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1 - Basis of Presentation

The interim financial information included herein is unaudited; however, such information reflects all adjustments (consisting solely of normally recurring adjustments) which are, in the opinion of management, necessary for a fair statement of results for the interim periods. The results of operations for the three-month and six-month periods ended August 31, 2001 is not necessarily indicative of the results to be expected for the full year.

Substantially all inventories represent finished goods held for sale.

2 - Contingent Liabilities

The Company has an arrangement with an HVACR equipment manufacturer and a field warehouse agent whereby HVACR equipment is held for sale in bonded warehouses located at the premises of the Company's operations in Georgia, Colorado and Tennessee, with payment due only when products are sold. Such inventory is accounted for as consigned merchandise and is not recorded on the Company's balance sheet. As of August 31, 2001, the cost of such inventory held in the bonded warehouses was $12,150,358.

The terms of the consignment agreement with the supplier further provide that the Company upon demand by the supplier must purchase merchandise not sold within a specified period of time. The Company believes that substantially all consigned merchandise will be sold in the ordinary course of business before any purchase obligation is incurred.

3 - Income Taxes

The current provision for income taxes consists principally of federal alternative minimum taxes and state income taxes. The provision for deferred taxes consists of a reduction of future deferred benefits expected to be realized as a result of the anticipated expiration of net operating loss carryforwards in fiscal 2003. The Company has net operating loss and tax credit carryforwards which offset substantially all of its federal taxable income.

4 - Debt

The Company has a revolving line of credit arrangement with a commercial bank ("Bank"). The maximum amount that may be borrowed under the revolving line of credit is $25 million, including up to $1 million for letters of credit. The maturity date of the credit facility is May 2003, with an automatic extension for one-year periods unless either party gives notice of termination to the other. At August 31, 2001, the Company had $22.2 million outstanding under the facility.

Because of lower than expected net income in the first two quarters of fiscal 2002, as of August 31, 2001, the Company was not in compliance with two financial covenants in its loan agreement with the Bank, and, to date, has not either obtained a waiver from the Bank or negotiated a revision to the covenants. Therefore, according to the strict provisions of the loan agreement, the Company's revolving line of credit is callable, and, as required by generally accepted accounting principles, such indebtedness is classified as a current liability in the balance sheet as of August 31, 2001.

The Bank has given no indication to date that it would intend to exercise any of its rights under the loan agreement in the event of default. Management has initiated discussions with the Bank concerning the financial covenants in the loan agreement and expects to reach an agreement before the end of fiscal 2002 to amend the relevant covenants and waive events of non-compliance. So long as the Company's ability to access its revolving credit facility remains unimpaired, management believes that cash flows from operations and the borrowing availability under the line of credit will provide sufficient liquidity to meet the Company's working capital requirements for existing operations, debt service and expected capital expenditures.

5 - Recently Issued Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have definite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of fiscal 2003, beginning March 1, 2002. The impact of applying the provisions of the Statement has not yet been determined. The maximum possible increase to income before income taxes on an annual basis as a result of the nonamortization provision is approximately $150,000.

6 - Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

	Six Months Ended August 31,		Three Months
	2001	2000	2001
Numerator:			
Net income	$ 1,439,945	$ 1,086,596	$ 1,044,342
Numerator for basic and diluted earnings per share - income available to common stockholders	$ 1,439,945	$ 1,086,596	$ 1,044,342
Denominator:			
Denominator for basic earnings per share - weighted average shares	10,681,294	10,671,103	10,681,294
Effect of dilutive securities:			
Employee stock options		32,521	
Warrants	10,753	587,356	21,506

Dilutive potential common shares	10,753	619,877	21,506
Denominator for diluted earnings per share - adj. weighted average shares and assumed conversions	10,692,047	11,290,980	10,702,800
Basic earnings per share	$ .13	$ .10	$ .10
Dilutive earnings per share	$ .13	$ .10	$ .10

ACR GROUP, INC. AND SUBSIDIARIES

Item 2. - Management's Discussion and Analysis of Financial Condition and Results of Operations

Comparison of Results of Operations for the Six-Month and Three-Month Periods Ended August 31, 2001 and August 31, 2000

Six Months Ended August 31, 2001 Compared to 2000

Net income increased to $1,439,945 in the six-month period ended August 31, 2001 (fiscal 2002) from $1,086,596 in the six-month period ended August 31, 2000 (fiscal 2001), an increase of 33%. Net income in fiscal 2002 includes a non-cash charge to deferred income taxes of $200,000. Excluding this charge, net income in fiscal 2002 would have increased 51% over the same period in fiscal 2001. The improvement in pre-tax income in fiscal 2002 was generally attributable to an increase in same-store sales and to a decline in operating losses at recently opened branches. From October 1999 through December 2000, the Company opened 12 branch operations. Such new branches typically incur costs prior to opening for personnel and preparing for business operation, and subsequently for 12 to 18 months as sales ramp up to a breakeven volume. In the six-month periods ended August 31, 2001 and 2000, aggregate operating losses for the 12 branches referred to above were approximately $190,000 and $360,000, respectively.

Consolidated sales increased 17% in the six-month period ended August 31, 2001, compared to the same period in 2000. Sales at the ten branch operations opened during fiscal 2001 aggregated $8.5 million in the six-month period ended August 31, 2001, compared to $0.6 million in the six-month period ended August 31, 2000. Same-store sales for the 37 branches open more than one year at the beginning of the fiscal year (March 1) increased 9% in the six-month period ended August 31, 2001, compared to a decrease of 2% in same-store sales in the same period of 2000. Same-store sales growth occurred at over 70% of the Company's branches, with the highest growth rates occurring in Florida and the western region of the United States. Sales of new lines of HVACR equipment, which were first introduced in fiscal 2001, contributed significantly to the sales increase at these operations.

The Company's gross margin percentage on sales was 21.5% for the six-month periods ended August 31, 2001 and 2000. Lower than average gross margin percentages at the Company's new branch operations were offset by continued reductions in the net purchase cost of inventory through national buying arrangements. In addition, the gross margin percentage at the Company's sheet metal fabrication operation benefited by reductions in commodity steel prices while maintaining its sale prices of finished goods.

Selling, general and administrative ("SG&A") expenses increased 16% in the six-month period ended August 31, 2001 compared to the same period of 2000, because of the costs associated with the new branch operations. Expressed as a percentage of sales, SG&A expenses decreased from 18.5% in 2000 to 18.3% in 2001, as the Company gained operating leverage from same-store sales growth. Increases in both workers compensation costs and transportation costs attributable to fuel prices contributed to the overall increase in SG&A expenses.

Interest expense increased 3% from 2000 to 2001, compared to a 20% increase in borrowings from the previous year, as lower interest rates on the Company's variable rate debt mitigated the cost of additional debt incurred to finance the new branch openings in fiscal 2001. As a percentage of sales, interest expense decreased from 1.6% in 2000 to 1.4% in 2001. Other non-

operating income, which consists primarily of finance charge collections, increased 31% from 2000 to 2001.

The current provision for income taxes consists principally of federal alternative minimum taxes and state income taxes. The provision for deferred taxes consists of a reduction of future deferred benefits expected to be realized as a result of the anticipated expiration of net operating loss carryforwards in fiscal 2003. However, as a result of the Company's continued use of tax loss carryforwards, the Company will have minimal liability for Federal income taxes through fiscal 2003. See Liquidity and Capital Resources, below.

Three Months Ended August 31, 2001 Compared to 2000

Net income increased to $1,044,342 in the quarter ended August 31, 2001 from $886,261 in the quarter ended August 31, 2000, an increase of 18%. Excluding the provision for deferred income taxes of $200,000 recorded in the quarter ended August 31, 2001, net income would have increased 40% compared to the same quarter of 2000. Such increase in results of operations was attributable to the same factors described above with respect to the six-month period ended August 31, 2001. In the quarters ended August 31, 2001 and 2000, aggregate operating losses of the branches opened since October 1999 were approximately $65,000 and $275,000, respectively.

Sales increased 16% from the second quarter of fiscal 2001 to fiscal 2002, with same-store sales increasing 8% for branches open for more than one year at the beginning of the fiscal year. Sales at the ten branch operations opened during fiscal 2001 aggregated $4.6 million in the quarter ended August 31, 2001, compared to $0.5 million in the quarter ended August 31, 2000. Sales in Texas increased at a double-digit rate in the quarter as the Company added outside sales personnel in the state and temperatures reached customary summer levels from mid-July through August. In contrast, after several successive quarters of double-digit sales growth, the Company's operations in California experienced a small same-store sales decline as a result of both unseasonably cool temperatures and reaction to the state's energy crisis.

The Company's gross margin percentage on sales was 21.3% for the quarter ended August 31, 2001, compared to 21.5% in 2000. Such decline is attributable both to a lower than average gross margin of 20.0% at the new branches and to market share gains from sales to high-volume customers that typically purchase products at highly competitive prices.

SG&A expenses as a percentage of sales decreased from 17.8% in 2000 to 17.6% in 2001, because of the operating leverage associated with same-store sales growth. Interest expense decreased 10% from 2000 to 2001 as a result of lower average interest rates on the Company's variable rate debt.

Liquidity and Capital Resources

Current assets increased 16% from February 28, 2001 to August 31, 2001, compared to a 26% increase during the same period in 2000, principally because of an increase in accounts receivable that resulted from the seasonal increase in sales. Gross accounts receivable represented 44 days of gross sales as of August 31, 2001 compared to 45 days at August 31, 2000, reflecting a continuous focus on credit management and aggressive collection of delinquent accounts. Inventory from the end of February to the end of August increased by 5% in 2001, compared to an increase of 20% in 2000. Approximately 60% of the inventory increase in 2000 was at branches opened in the first two quarters of the fiscal year.

The Company has credit facilities with a commercial bank ("Bank") which

include an $25 million revolving line of credit, including up to $1 million for letters of credit, and a $1 million term loan facility for capital expenditures. During the quarter ended August 31, 2001, the Company borrowed $183,591 against the capital expenditure facility. At August 31, 2001, the Company had available credit of $1.7 and $0.4 million under the revolving credit line and the capital expenditure term loan facility, respectively. At August 31, 2001, the outstanding balance on the revolving credit line and the term loan facility bears interest at LIBOR plus 2.75% (currently 6.33%).

Because of lower than expected net income in the first two quarters of fiscal 2002, as of August 31, 2001, the Company was not in compliance with two financial covenants in its loan agreement with the Bank, and, to date, has not either obtained a waiver from the Bank or negotiated a revision to the covenant. Therefore, according to the strict provisions of the loan agreement, the Company's revolving line of credit is callable, and, as required by generally accepted accounting principles, such indebtedness is classified as a current liability in the balance sheet as of August 31, 2001. The Bank has given no indication to date that it would intend to exercise any of its rights under the loan agreement in the event of default. Management has initiated discussions with the Bank concerning the financial covenants in the loan agreement and expects to reach an agreement before the end of fiscal 2002 to amend the relevant covenants and waive events of non-compliance. So long as the Company's ability to access its revolving credit facility remains unimpaired, management believes that cash flows from operations and the borrowing availability under the line of credit will provide sufficient liquidity to meet the Company's working capital requirements for existing operations, debt service and expected capital expenditures.

The Company has approximately $8 million in tax loss carryforwards of which approximately $7 million expire by fiscal 2003. Such operating loss carryforwards will substantially limit the Company's federal income tax liabilities in the near future.

Recently Issued Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill and intangible assets deemed to have definite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Other intangible assets will continue to be amortized over their useful lives.

The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of fiscal 2003, beginning March 1, 2002. The impact of applying the provisions of the Statement has not yet been determined. The maximum possible increase to income before income taxes on an annual basis as a result of the nonamortization provision is approximately $150,000.

Seasonality

The Company's sales volume and, accordingly, its operating income vary significantly during its fiscal year. The highest levels of sales occur during the times of the year when climatic conditions require the greatest use of air conditioning, since the Company's operations are concentrated in the warmer sections of the United States. Accordingly, sales will be highest in the Company's second quarter ending August 31, and will be lowest in its fourth quarter.

Inflation

The Company does not believe that inflation has had a material effect on its results of operations in recent years. Generally, manufacturer price increases attributable to inflation uniformly affect both the Company and its competitors, and such increases are passed through to customers as an increase in sales prices.

Safe Harbor Statement

This Quarterly Report on Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements include statements concerning plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements, which are other than statements of historical facts. Forward-looking statements involve risks and uncertainties that could cause actual results or outcomes to differ materially. The Company's expectations and beliefs are expressed in good faith and are believed by the Company to have a reasonable basis, but there can be no assurance that management's expectations, beliefs or projections will be achieved or accomplished. The forward-looking statements in this document are intended to be subject to the safe harbor protection provided under the securities laws. In addition to other factors and matters discussed elsewhere herein, the following are important matters that, in the view of the Company, could cause actual results to differ materially from those discussed in the forward-looking statements: the ability of the Company to continue to expand through acquisitions, unusual weather conditions, the effects of competitive pricing and general economic factors.

Item 3. - Quantitative and Qualitative Disclosures About Market Risk

The Company is subject to market risk exposure related to changes in interest rates on its senior credit facility, which includes revolving credit and term notes. These instruments carry interest at a pre-agreed upon percentage point spread from either the prime interest rate or LIBOR. Under its senior credit facility the Company may, as its option, fix the interest rate for certain borrowings based on a spread over LIBOR for 30 days to 6 months. At August 31, 2001 the Company had $22.2 million outstanding under its senior credit facility. The Company's objective in maintaining these variable rate borrowings is the flexibility obtained regarding lower overall costs as compared with fixed-rate borrowings.

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PART II - OTHER INFORMATION

Item 4. - Results of Votes of Security Holders

At the Annual Meeting of Shareholders on August 16, 2001, the shareholders of the Company voted on and approved the following issue:

Election of Directors for a term of one year expiring at the next Annual Meeting of Shareholders:

	Shares For	Shares Withheld
Anthony R. Maresca	9,687,980	60,940
Ronald T. Nixon	9,704,390	44,530
Roland H. St. Cyr	9,715,380	33,540
A. Stephen Trevino	9,665,854	83,066
Alex Trevino, Jr.	9,722,675	26,245

Item 6. - Exhibits and Reports on Form 8-K

(a) Reports on Form 8-K. None

SIGNATURES

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

ACR GROUP, INC.

October 15, 2001	/s/ Anthony R. Maresca
Date	Anthony R. Maresca Senior Vice-President and

Chief Financial Officer