

Palmer G. Lewis Co., Inc.

1985

ANNUAL REPORTS
Palmer G. Lewis Co., Inc. 1985

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A Leading
Distributor
of Building
Related
Products in
the West



1985 Annual Report

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The Company

Pictured on the front cover is the Company's corporate headquarters, which also serves as headquarters to the Building Material Division. The Building Material Division is a wholesale distributor of a broad line of basic building products. It operates 13 service centers from central California to Alaska. Sea-Pac Sales Company, the largest of three wholly owned subsidiaries, has five locations in the Northwest. It distributes Armstrong resilient flooring, carpeting, Bruce wood flooring and appliances manufactured by Gibson, Sharp and Modern Maid. Another subsidiary is Cochrane Northwest, Inc., which operates three wholesale locations in Washington State serving the high pressure laminate, ceramic tile, and floor covering accessory market. The Company also operates Truck Service, Inc., a truck repair shop and Marmon Truck dealer in Kent, Washington.

Palmer G. Lewis Co., Inc.

Financial Highlights

Years Ended	Jan. 31, 1986	Jan. 25, 1985	% Change
Net Sales	\$140,773,409	\$144,382,029	-2
Net Income before Tax	\$ 1,449,484	\$ 1,321,831	+10
Net Income after Tax	\$ 878,484	\$ 1,072,831	-18
Net Income per Share	\$.23	\$.29	-21
Cash Dividends	\$.28	\$.27	+4
Stock Dividends	4%	4%	—
Total Assets	\$ 50,448,924	\$ 53,805,183	-6
Stockholders' Equity	\$ 33,129,107	\$ 33,178,934	—
Average Shares Outstanding	3,900,572	3,640,181	+7

Net income per share, cash dividends, and average shares outstanding have been adjusted for the stock dividends paid in October 1985 and September 1984.

The Company's Common Stock is traded on the Over-the-Counter market under the NASDAQ symbol LWIS. The following table shows the cash dividends paid or declared and the high and low selling prices for the PGL Common Stock for each fiscal quarter of 1986 and 1985 as reported for National Market Issues. Prices and dividends per share have been adjusted for 4% stock dividends in October 1985 and September 1984 and rounded to the nearest 1/8.

Quarterly Stock Prices

Fiscal Period	Selling Price		Dividends Per Share
	High	Low	
1985 1st Quarter	\$9 ⁵ / ₈	\$7 ¹ / ₄	\$.06
2nd Quarter	7 ⁵ / ₈	6 ⁷ / ₈	.07
3rd Quarter	8 ³ / ₄	6 ⁷ / ₈	.07
4th Quarter	9 ¹ / ₈	6 ⁷ / ₈	.07
1986 1st Quarter	\$9 ¹ / ₂	\$7 ³ / ₄	\$.07
2nd Quarter	8 ⁵ / ₈	7 ⁵ / ₈	.07
3rd Quarter	7 ⁷ / ₈	6 ³ / ₈	.07
4th Quarter	8 ¹ / ₄	7	.07

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Message to PGL Shareholders



*John N. Anderson
Vice Chairman and
Chief Executive Officer*

In the late 70's and early 80's it was felt that a housing boom would occur if rates fell. This boom hasn't occurred. Why?

Opinions vary greatly on this subject. Some creditable people feel the housing need has been overestimated, and that the market really is sustainable at a figure from 1.8 to 2.0 million starts per year. The cost of housing remains high and many people feel rates will go still lower and are waiting. Because of very low inflation rates, there is much less tendency to regard housing as an "investment opportunity."

Take your pick!!

The year ended January 31, 1986, as predicted a year ago in this report, has been a year of challenges and changes at PGL. While the Company's overall profit goals have not been achieved, there have been important accomplishments which bode well for improved performance. Although after-tax earnings were down, it is significant to note that before-tax earnings were up nearly 10% for the year. Our tax rate was higher this year due to fewer investment tax credits available. Of even greater significance is that the fourth quarter performance showed important gains over the comparable quarter last year. Let's review the various PGL companies.

Cochrane Northwest, Inc. (CNI)

Early in the year we purchased the outstanding minority interest in CNI, enabling PGL to invest in a turnaround for this troubled subsidiary. An impressive turnaround has been accomplished and CNI has made a significant contribution to the annual PGL profits. Cochrane distributes high pressure laminates and floor covering accessories in Washington State. This is a growth company which should continue to perform well.

Sea-Pac Sales Company

While Sea-Pac again contributed the largest share of PGL profit dollars, the year was not without problems. Sea-Pac's contribution was lower this year than in the previous year. Sea-Pac is a distributor of floor coverings and appliances. The appliance market slipped both in dollar volume and in margins. Sea-Pac had new product introduction costs and internal operational changes which were costly. In 1986 Sea-Pac should show profit improvement over 1985.

Truck Service, Inc. (TSI)

TSI and its truck repair business showed meaningful improvement during the year.

TSI has found an important niche in its market area and should continue to perform well.

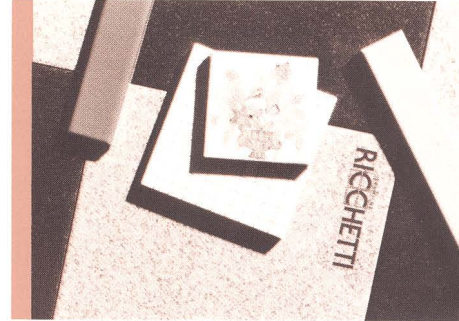
Quality Coatings, Inc.

During 1985 PGL divested its minority interest in this paint and sundries distribution company. It was determined that we could achieve a better return on these assets in other areas.

PGL Building Material Distribution Division

The greatest operation and management challenges still appear to be in the building material distribution segment of our business — the traditional PGL volume base. Last year, profitability improved slightly. Our policy has been to challenge everything we do in this division — in effect, a zero base review. Many changes have been instituted during the year and the large majority of these have proven worthwhile. The challenge is, of course, to achieve a reasonable profit return on investment which means we must gain a larger

During 1985 Cochrane Northwest became a distributor of Ricchetti ceramic tile manufactured in Italy.



What effect has the apparent error in estimating housing requirements had on our industry?

There has developed manufacturing over capacity in important construction products, i.e. wood products, roofing, insulation, etc., which has driven down prices to near cost. Some plants are inoperative. Margins are minimal, affecting distribution as well as manufacturing. In both manufacturing and distribution, marginal companies are closing operations. The strong will succeed and supply and demand will find their level over time.

share of the market. Adequate margins are difficult to achieve. Operational costs have been reduced but they are still higher than the lowest cost operators. The division is operating with 12% fewer employees than a year ago and can sustain substantially higher sales volumes at these current employment levels. Our truck fleet, PGL's single largest expense, has been reduced by 20% for greater efficiency. We are reaching deeper into our organization than ever before to bring profitable operational solutions to this division. The recent consoli-

dation of our Alaska division-terminal at Tacoma, Washington into an expanded Auburn, Washington facility has had the effect of lowering costs while better serving both our Alaska and our Washington customers. The costs of closing the Tacoma-terminal and consolidating it into Auburn were absorbed in the fourth quarter, with the benefits to come in this new year. Although the Oregon-Idaho region and the California-Nevada region still

had problems, their performance was improved over the previous year. Unfortunately, because of a weak economy, the important Alaska market suffered some decline in sales and profits. So much for what happened last year. What do we see as our present position? PGL's financial strength has never in its history been as strong as it is now. Because we have redirected the use of our assets during the year, we have been able to eliminate much of our borrowing requirements. Our current ratio of 3 to 1 is excellent by any business standard. While the creation of profit through best use of our assets is the challenge, financial strength will make that easier and safer. The benefits of the major changes made during this past year should begin to show in the new year. Interest rates are at recent historical lows. Although housing starts have not responded in volume as great as previously predicted, there certainly is improved action in the housing field. While Alaska is vulnerable to the

What is PGL doing to cope with oversupply and low margin problems?

We approach these problems from two directions —

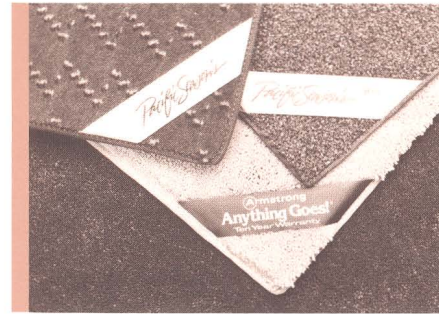
- A. We are challenging everything we do from a cost or efficiency viewpoint. Is the function necessary? Can we operate more efficiently? We are beginning to demonstrate that we can.
- B. We are concentrating on products and customers which will enable PGL to continue to justify investment in the distribution business. There is evidence that important segments of the building material industry recognize the long range need for our services.

In late 1985 Champion/U.S. Plywood closed their distribution outlets in the Pacific Northwest and Northern California. Palmer Lewis assumed the distribution of a number of fine U.S. Plywood products which includes their complete line of prefinished paneling.



present oil price squeeze, there is a feeling in Alaska that business can be retained at 1985 levels. Alaskans are optimistic by nature and PGL will be supporting their optimism to the utmost. Insurance rates are a big problem as a whole. Insurance costs will be much higher this year and in a low margin industry, this added cost doesn't help. Competition remains tough. Even with a few more competitors dropping out in 1985, we are scrambling for our share of the market. The achievement of necessary gross margins remains a big challenge for everyone in the industry. Proposed tax reform, if instigated, could have a positive effect on PGL's after-tax earnings in future years. In 1986, management's attention will continue to be directed toward challenging every operational activity, identifying problems and seeking solutions. Only through greater market penetration and improved efficiencies can we operate our existing

Sea-Pac Sales has supplemented its primary high quality Armstrong carpet line with Sea-Pac's own Pacific Seasons carpet products.



As PGL's liquid asset base changes, due to operational changes in the recent past or near future, how will those assets be put to work?

Specific answers are not available. What is important from a shareholder standpoint is that PGL management and directors know that the obligation to shareholders is to give an adequate return on investment, on a long range basis. This position does not assume the need to achieve the return *only* through businesses in which PGL has operated in the past.

businesses at a reasonable profit level yielding an adequate return on investment. While our basic businesses may not be in the glamorous category, I can assure our shareholders that the determination of the PGL staff (most of whom are shareholders) is to make this company a good long-term investment. I am optimistic about our future results.

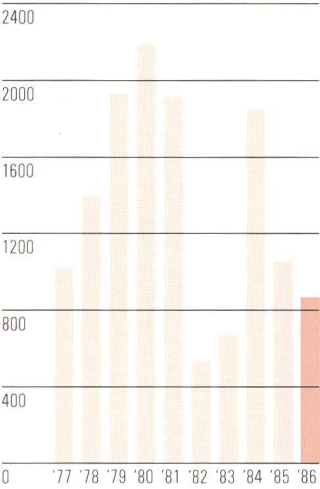
John N. Anderson
Vice Chairman and
Chief Executive Officer

**Selected Consolidated
Financial Information**

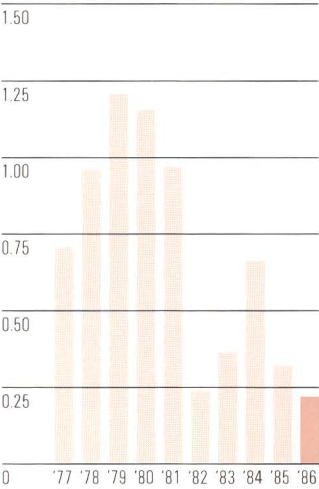
Fiscal Years Ended January	1986	1985	1984	1983	1982
Income Statement Data:					
Net Sales	\$140,773,000	\$144,382,000	\$121,044,000	\$103,497,000	\$111,192,000
Gross Profit %	17.5%	16.8%	17.0%	17.0%	15.4%
Interest Expense	704,000	1,346,000	982,000	1,725,000	2,384,000
Depreciation & Amortization	2,322,000	2,080,000	1,599,000	1,397,000	1,291,000
Income Taxes	571,000	249,000	1,059,000	335,000	329,000
Net Income	878,000	1,073,000	1,820,000	678,000	488,000
Net Income Per Share	.23	.29	.64	.33	.24
Average Shares Outstanding	3,901,000	3,640,000	2,828,000	2,060,000	2,051,000
Balance Sheet Data:					
Total Assets	50,449,000	53,805,000	42,490,000	38,966,000	38,213,000
Working Capital	22,238,000	20,861,000	17,501,000	8,115,000	11,226,000
Long Term Debt (net of Current Portion)	2,311,000	2,526,000	2,236,000	2,360,000	5,341,000
Capitalized Leases (net of Current Portion)	2,288,000	2,413,000	2,525,000	2,620,000	2,706,000
Stockholders' Equity	33,129,000	33,179,000	27,029,000	16,490,000	16,291,000
Dividends Per Common Share:					
Cash	.28	.27	.26	.25	.24
Stock	4%	4%	4%	4%	4%
Other Data:					
Net Capital Expenditures	672,000	3,648,000	1,846,000	1,579,000	1,116,000
Cash Flow (net income + non-cash items)	3,741,000	3,551,000	3,418,000	2,049,000	1,773,000
Profit Sharing Trust Value	5,738,000	5,173,000	5,165,000	4,778,000	4,288,000
Profit Sharing Disbursements	446,000	820,000	452,000	755,000	313,000
Number of Employees	462	492	403	369	363
Net Income					
As a % of Average Stockholders' Equity	2.6%	3.6%	7.5%	4.1%	3.0%
As a % of Sales	.62%	.74%	1.50%	.66%	.44%

Ten Year Review

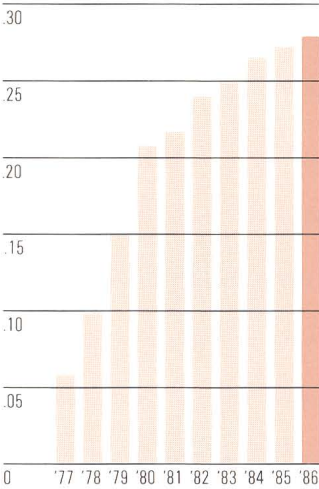
Net Income
\$ in thousands



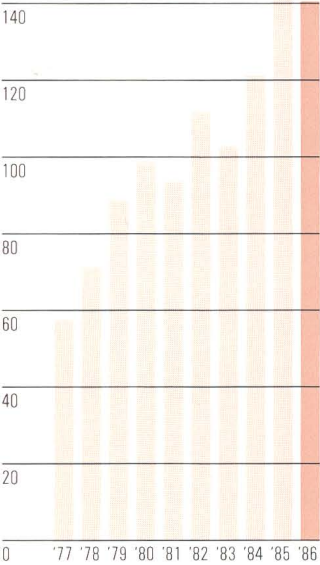
Net Income Per Share
in \$



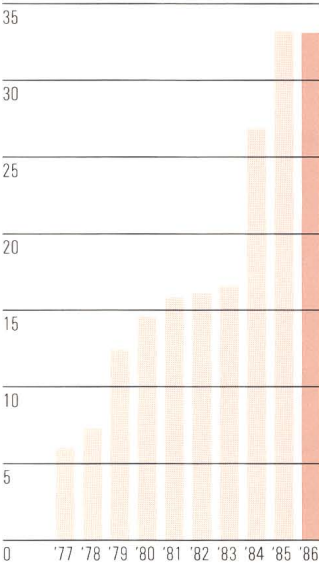
Cash Dividend Per Share
in \$



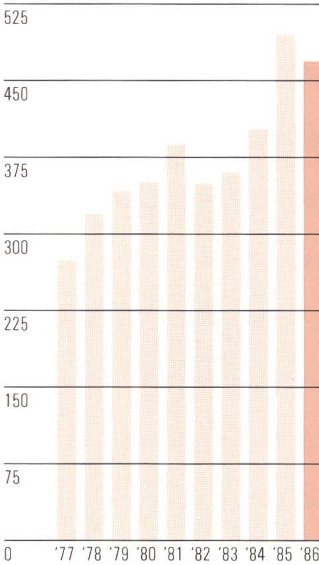
Sales
\$ in millions



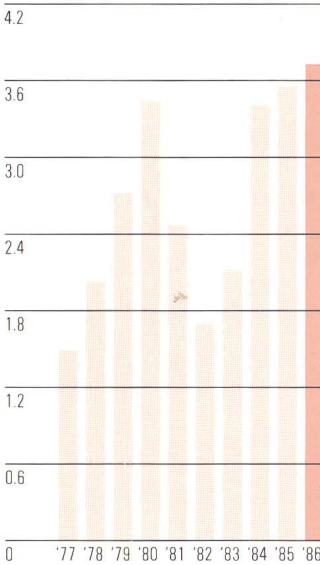
Net Worth
\$ in millions



Number of Employees



Cash Flow
\$ in millions



Operations

Sales for fiscal 1986 were \$140.8 million, down 2% from the \$144.4 million for fiscal 1985. The sales results for fiscal 1985 were up 19% from the \$121.0 million for fiscal 1984. Included in fiscal 1986 and 1985 were \$31.1 million and \$24.7 million respectively for Sea-Pac Sales, which was acquired in May 1984. The Company's sales and earnings since fiscal 1980 have been adversely affected by high interest rates and a resulting slowdown in the building industry. In recent years inflation has not been a factor in most of the Company's product lines. In fact, in fiscal 1985 the Company actually had deflation in many commodity items.

In fiscal 1984 the Company began to feel a turnaround from the recession of the previous two years. The improvement in the Company's market continued into the first quarter of fiscal 1985. However, in May, 1984, rising interest rates again curtailed sales growth for the building materials division of the Company. Intense competition had a negative effect on profit margins and the Company experienced inventory losses during the year. The slowdown in the Company's business was compounded by the growing slowdown in the Alaska economy. These business conditions continued through the first two quarters of fiscal 1986 with both sales and profits down from the previous year. However, the impact of declining interest rates began to improve sales and profitability during the third quarter. The Company has been working hard to reduce its operating costs and increase its efficiencies. The effect of these efforts, combined with an improving economy, resulted in improved profitability in the fourth quarter of fiscal 1986 over the previous year.

During the last fiscal year the Company acquired the remaining outstanding stock of its subsidiary, Cochrane Northwest, and was able to turn Cochrane into a profitable entity. Like fiscal 1985, Sea-Pac was the major contributor to the company's net profits. However, Sea-Pac's results did not equal those of the previous year. TSI, the Company's truck repair shop, had a very satisfactory year, with profits up substantially. The building material division was able to improve profitability over fiscal 1985 but results were still far from satisfactory.

Interest expense was down significantly over the previous year as a result of lower borrowings, combined with lower interest rates. However, as a result of substantial capital expenditures made during fiscal 1985 depreciation expense continued to grow. In spite of the economy the Company had modest success in improving its gross margin during the year. As a result, pre-tax income improved modestly over fiscal 1985. However, the Company's income tax rate was up significantly in fiscal 1986 over 1985, primarily as the result of less investment

tax credit. This resulted in an 18% decrease in after-tax income. Earnings per share decreased slightly more because of higher average shares outstanding in the current fiscal year.

Balance Sheet Data

Although total assets declined the Company's balance sheet continued to strengthen. Working capital increased by approximately \$1.4 million and the Company's current ratio approaches 3 to 1. Long-term debt continues to decline. As a result of lower inventories and accounts receivable, combined with sharply curtailed capital expenditures, the Company for the first time at year-end had no short-term bank borrowing and, in fact, was investing close to \$1.5 million. The Company's borrowing peaked at \$5.9 million during the year, down substantially from the excess of \$13 million for fiscal 1985 and the \$9.1 million for fiscal 1984. Stockholders' equity, which increased significantly in 1984 due to a public offering, and in 1985 due to the Sea-Pac acquisition, remained constant.

Dividend

The Company continued to pay cash dividends of 28¢ per share (.07¢ per quarter), the same rate it has paid over the past six fiscal years. Dividend data has been restated downward to reflect the effect of the 4% stock dividend that the Company has paid since 1968. The Company has paid uninterrupted cash dividends every year since it initiated its dividend policy in 1960.

Other Data

During the year the Company sharply curtailed its capital expenditures. In addition, it reduced its trucking fleet by approximately 20%. Cash flow approached \$3.8 million and was adequate to fund the Company's dividend policy. Although the Company's profit sharing contribution was down, the fund had an excellent return on its investments and as a result, continued to grow. The total number of employees declined approximately 6% from the end of the previous year, reflecting the continued efforts to improve efficiencies. During the year the company set up a 401K program, as authorized under the Internal Revenue code. Although it is non-contributory on the part of the Company, it does provide for tax-free savings for retirement by the employees. In addition, the Company set aside approximately \$51,000 in fiscal 1986 for its employee stock ownership plan (PAYSOP). This program allows a tax credit for Company stock distributions into a trust for its employees. In addition, over 50% of the eligible employees are enrolled on a continuous basis in the employees' stock purchase plan and a significant number of employees are shareholders of the Company.

**CONSOLIDATED
BALANCE SHEETS**
Palmer G. Lewis Co., Inc.
and Subsidiaries

Assets	January 31, 1986 and January 25, 1985	1986	1985
Current Assets:			(Note 2)
Cash and cash equivalents		\$ 1,871,083	\$ 480,755
Receivables, less allowance for doubtful accounts of \$475,000 in 1986 and \$627,000 in 1985		14,127,039	16,043,144
Current portion of notes receivable		343,716	408,585
Inventories (Notes 1 and 2)		17,114,837	17,613,560
Income tax receivable		—	720,451
Prepays		382,317	208,518
Total current assets		33,838,992	35,475,013
Land, Buildings and Equipment, at cost (Notes 1 and 4):			
Land and land improvements		2,010,194	2,107,677
Buildings		8,534,776	8,943,160
Equipment		9,250,522	9,715,831
Property held under capital leases		3,259,477	3,259,477
Furniture and fixtures		2,375,845	2,141,116
Construction in progress		297,644	—
		25,728,458	26,167,261
Less-accumulated depreciation and amortization		(10,946,622)	(9,742,959)
		14,781,836	16,424,302
Other Assets:			
Notes receivable, net of current portion shown above		1,155,073	992,696
Investments		—	430,066
Other		673,023	483,106
		1,828,096	1,905,868
		\$50,448,924	\$53,805,183

The accompanying notes are an integral part of these balance sheets.

Liabilities and Stockholders' Equity	1986	1985
Current Liabilities:		(Note 2)
Short-term notes payable (Note 3)	\$ —	\$ 4,200,000
Current portion of long-term debt and obligations under capital leases	368,154	360,243
Accounts payable	8,690,330	7,363,552
Accrued salaries and wages	1,264,036	1,278,568
Other accrued liabilities	1,073,926	1,410,849
Income taxes payable	204,518	—
Total current liabilities	11,600,964	14,613,212
Long-Term Debt (Note 4)	2,526,019	2,746,974
Obligations under Capital Leases (Note 4)	2,440,988	2,552,306
Less-current portion shown above	(368,154)	(360,243)
	4,598,853	4,939,037
Deferred Income Taxes (Note 5)	1,120,000	1,074,000
Commitments (Note 6)		
Stockholders' Equity (Note 1, 2 and 7):		
Common stock par value \$1.00—		
Authorized 8,000,000 shares;		
Issued and outstanding 3,911,643 shares in 1986 and 3,741,025 shares in 1985	3,911,643	3,741,025
Paid-in capital	26,198,036	25,218,789
Retained earnings	3,019,428	4,219,120
	33,129,107	33,178,934
	\$50,448,924	\$53,805,183

**CONSOLIDATED
STATEMENTS OF INCOME**
Palmer G. Lewis Co., Inc.
and Subsidiaries

For the three fiscal years ended January 31, 1986	1986	1985	1984
Net Sales (Note 8)	\$140,773,409	\$144,382,029	\$121,043,541
Cost and Expenses:			
Costs of goods sold	116,144,779	120,134,905	100,446,452
Selling, general and administrative expenses	20,955,850	20,247,700	15,665,218
Depreciation and amortization	2,322,235	2,079,614	1,598,542
Interest expense	704,337	1,345,667	982,212
Employees' profit sharing plan	83,751	244,427	356,874
Interest income	(476,199)	(488,314)	(294,167)
Other	(410,828)	(503,801)	(590,767)
	139,323,925	143,060,198	118,164,364
Income before Provision for Income Taxes	1,449,484	1,321,831	2,879,177
Provision for Income Taxes (Note 5)	571,000	249,000	1,059,000
Net Income	\$ 878,484	\$ 1,072,831	\$ 1,820,177
Per Share Data (Note 1)			
Net Income	\$.23	\$.29	\$.64
Dividends			
Cash	\$.28	\$.27	\$.26
Stock	4%	4%	4%

The accompanying notes are an integral part of these statements.

**CONSOLIDATED STATEMENTS
OF STOCKHOLDERS' EQUITY**

**Palmer G. Lewis Co., Inc.
and Subsidiaries**

For the three fiscal years ended January 31, 1986

	Common Stock		Paid-in Capital	Retained Earnings	Treasury Stock	
	Shares	Amount			Shares	Amount
Balance, January 28, 1983	1,845,777	\$1,845,777	\$ 9,393,800	\$5,288,202	(4,000)	\$ (38,000)
Sale of common stock to public	880,000	880,000	8,512,898	—	—	—
Sale of common stock under stock purchase and stock option plans (Note 7)	9,316	9,316	51,673	—	16,542	160,309
Purchase of treasury stock	—	—	—	—	(17,800)	(170,385)
Common stock dividend	108,505	108,505	1,071,487	(1,179,992)	—	—
Cash dividends	—	—	—	(725,060)	—	—
Net income	—	—	—	1,820,177	—	—
Balance, January 27, 1984	2,843,598	\$2,843,598	\$19,029,858	\$5,203,327	(5,258)	\$ (48,076)
Common stock issued for acquisition of Sea-Pac Sales Company (Note 2)	747,732	747,732	5,234,124	—	—	—
Sale of common stock under stock purchase and stock option plans (Note 7)	7,141	7,141	19,653	—	33,258	260,201
Purchase of treasury stock	—	—	—	—	(28,000)	(212,125)
Common stock dividend	142,554	142,554	935,154	(1,077,708)	—	—
Cash dividends	—	—	—	(979,330)	—	—
Net income	—	—	—	1,072,831	—	—
Balance, January 25, 1985	3,741,025	\$3,741,025	\$25,218,789	\$4,219,120	—	\$ —
Sale of common stock under stock purchase and stock option plans (Note 7)	21,143	21,143	119,905	—	14,888	109,104
Purchase of treasury stock	—	—	—	—	(15,000)	(110,000)
Retirement of common stock	(112)	(112)	(784)	—	112	896
Common stock dividend	149,587	149,587	860,126	(1,009,713)	—	—
Cash dividends	—	—	—	(1,068,463)	—	—
Net income	—	—	—	878,484	—	—
Balance, January 31, 1986	3,911,643	\$3,911,643	\$26,198,036	\$3,019,428	—	\$ —

The accompanying notes are an integral part of these statements.

**CONSOLIDATED
STATEMENTS OF CHANGES
IN FINANCIAL POSITION**

**Palmer G. Lewis Co., Inc.
and Subsidiaries**

For the three fiscal years ended January 31, 1986	1986	1985	1984
Sources of Working Capital:			
Operations			
Net income	\$ 878,484	\$1,072,831	\$1,820,177
Charges (credits) not affecting working capital—			
Depreciation and amortization	2,322,235	2,079,614	1,598,542
Provision for deferred income taxes	46,000	571,000	61,000
Other	494,421	(172,545)	(61,862)
Working capital provided from operations	3,741,140	3,550,900	3,417,857
Proceeds from—			
Sale of common stock	250,152	6,268,851	9,614,196
Long-term debt and obligations under capital leases	20,782	607,455	92,917
	4,012,074	10,427,206	13,124,970
Applications of Working Capital:			
Purchase of land, buildings and equipment	671,770	3,647,751	1,845,736
Reduction of long-term debt and obligations under capital leases	360,966	447,968	312,412
Cash dividends	1,068,463	979,330	725,060
Purchase of treasury stock	110,000	212,125	170,385
Increase in notes receivable and other, net	424,648	236,030	685,565
Net assets of acquired business, land, buildings and equipment (\$1,561,384); less long-term debt (\$18,631). Excludes working capital acquired (\$5,074,366). (Note 2)	—	1,542,753	—
	2,635,847	7,065,957	3,739,158
Increase in Working Capital	\$1,376,227	\$3,361,249	\$9,385,812
Working Capital Increased (Decreased) as follows:			
Current assets—			
Cash and cash equivalents	\$1,390,328	\$ 147,360	\$ (468,299)
Receivables	(1,916,105)	4,132,941	600,444
Current portion of notes receivable	(64,869)	195,171	88,414
Inventories	(498,723)	2,601,794	2,434,219
Income tax receivable	(720,451)	720,451	—
Prepays	173,799	37,236	(136,754)
	(1,636,021)	7,834,953	2,518,024
Current liabilities—			
Short-term notes payable	4,200,000	(3,100,000)	4,250,000
Current portion of long-term debt	(7,911)	(115,304)	3,023,061
Accounts payable	(1,326,778)	(659,051)	(71,247)
Accrued salaries and wages	14,532	(55,446)	(163,828)
Other accrued liabilities	336,923	(586,990)	(392,148)
Income taxes payable	(204,518)	43,087	221,950
	3,012,248	(4,473,704)	6,867,788
Increase in Working Capital	\$1,376,227	\$3,361,249	\$9,385,812

The accompanying notes are an integral part of these statements.

January 31, 1986
**NOTES TO CONSOLIDATED
FINANCIAL STATEMENTS**
Palmer G. Lewis Co., Inc.
and Subsidiaries

**1. Summary of
Significant
Accounting Policies**

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Palmer G. Lewis Co., Inc. (PGL) and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Inventories

Inventories consist of finished goods and are stated at the lower of cost, First-In-First-Out (FIFO), or market.

Depreciation and Amortization, Repairs and Maintenance

Buildings, equipment and property held under capital leases are depreciated using the straight-line method over the estimated useful lives of the assets. Estimated useful lives are summarized below:

Land improvements and buildings	10-40 years
Equipment	3-10 years
Property held under capital leases	20-25 years
Furniture and fixtures	5-10 years

Maintenance, repairs and minor replacements are expensed as incurred. Betterments and replacements of major assets are capitalized. The cost and related accumulated depreciation of property sold or retired is removed from the accounts and the resultant gain or loss is reflected in operations.

Income Taxes

Deferred income taxes are provided for the reporting of items differently between financial statement and income tax purposes. Investment tax credits are recognized currently as a reduction of income tax expense.

Net Income Per Share

Net income per share is based on the weighted average number of shares of common stock outstanding during each year (3,900,572 shares in 1986, 3,640,181 shares in 1985, and 2,828,409 shares in 1984) after giving effect to the stock dividends during the years.

Profit Sharing Plan

Contributions to the Company's profit sharing plan are made at the discretion of the Board of Directors.

Reclassifications

Certain reclassifications have been made to prior year financial statements in order to conform them to the current year's format.

2. Acquisition

On May 16, 1984 the Company issued 747,732 shares of PGL stock plus \$1,140,384 in cash for all of the outstanding stock of Seattle Pacific Sales Company (Sea-Pac). The transaction was accounted for as a purchase and accordingly the acquisition cost was allocated based on the fair value of Sea-Pac's net assets at May 15, 1984. Results of operations of Sea-Pac are included in the consolidated financial statements subsequent to May 15, 1984. Had Sea-Pac's results of operations been included for the full years ended January 25, 1985 and January 27, 1984, unaudited pro forma net sales and net income would have been \$153,700,000, \$151,407,000, \$929,000 and \$2,446,000, respectively.

In February 1985, Sea-Pac conformed its method of accounting for inventory from the Last-In-First-Out (LIFO) to the First-In-First-Out (FIFO) method used by PGL. Accordingly, the prior year's purchase price allocation of Sea-Pac has been restated. The effect of this change on 1985 and 1986 net income is not material.

3. Short-Term Notes Payable to Banks

At January 31, 1986, PGL had unsecured lines of credit with banks to borrow up to \$24,000,000 primarily at prime or lower. Information regarding short-term borrowings during the three fiscal years ended 1986 follows:

<i>(Dollar amounts in thousands)</i>	1986	1985	1984
Weighted average interest rate	8.7%	11.4%	10.2%
Average borrowings	\$1,754	\$7,086	\$3,175
Maximum amount of short-term borrowings at any month-end	5,900	13,350	9,100
Year-end short-term notes payable to banks	—	4,200	1,100
Year-end weighted average interest rate	—	9.1%	11.0%

4. Long-Term Debt and Obligations under Capital Leases

As of January 31, 1986, and January 25, 1985, long-term debt and obligations under capital leases consisted of the following:

<i>(Dollar amounts in thousands)</i>	1986	1985
9½% note payable to bank, secured by a mortgage on certain land and buildings, payable in monthly installments of \$3, including interest to January, 1988.	\$ 279	\$ 282
8½% to 9¾% notes payable, secured by mortgages on certain land, buildings and equipment, payable in monthly installments of \$17, including interest to 1994.	1,619	1,664
10% note payable, secured by a mortgage on certain land and buildings, payable in annual installments of \$100 plus interest to July, 1989.	400	500
Other	228	301
Total long-term debt	2,526	2,747
Capital lease obligations, \$32 payable monthly, including interest imputed at rates from 9% to 14%, to 1996.	2,441	2,552
Less-current portion	(368)	(360)
	\$4,599	\$4,939

The capital leases are for certain branch and office facilities. One of the leases is with a partnership in which a partner is the Chairman of the Board and a stockholder of PGL. As of January 31, 1986 and January 25, 1985, the capital lease obligation was \$1,340,000 and \$1,458,000 respectively, and the annual payments to the partnership during each of the three fiscal years ended 1986 were \$255,000. PGL may lease the facility for a term of eight more years, expiring in 1993, at the current rate or exercise an option to purchase the property at any time at fair market value. There is a renewal option at the end of the lease for an additional ten years at the then fair market value.

The following summarizes long-term debt maturities for the five fiscal years ending 1991 and subsequent years:

<i>Fiscal Year Ending (Amounts in thousands)</i>	Long-Term Debt	Capital Lease Obligations	Total
1987	\$ 215	\$ 153	\$ 368
1988	171	171	342
1989	140	187	327
1990	141	205	346
1991	42	226	268
Subsequent years	1,817	1,499	3,316
	2,526	2,441	4,967

5. Income Taxes

For the three fiscal years ended 1986, the provision for income taxes consisted of the following:

<i>(Amounts in thousands)</i>	Federal	State	Total
January 31, 1986			
Current taxes payable	\$ 779	\$ 50	\$ 829
Less-tax credits	(121)	—	(121)
Deferred taxes payable	(137)	—	(137)
Provision for income taxes	\$ 521	\$ 50	\$ 571
January 25, 1985			
Current taxes payable	\$ 364	\$ 42	\$ 406
Less-tax credits	(326)	—	(326)
Deferred taxes payable	169	—	169
Provision for income taxes	\$ 207	\$ 42	\$ 249
January 27, 1984			
Current taxes payable	\$1,090	\$ 104	\$1,194
Less-tax credits	(196)	—	(196)
Deferred taxes payable	61	—	61
Provision for income taxes	\$ 955	\$ 104	\$1,059

The tax effect of timing differences resulting in deferred income taxes for each fiscal year are as follows:

<i>(Amounts in thousands)</i>	1986	1985	1984
Depreciation	\$ 184	\$ 135	\$ (8)
Installment sales	33	(8)	133
Retirement benefit plans	24	(54)	(18)
Pension plan conversion	(196)	—	—
Inventory adjustment	(99)	56	—
Other-net	(83)	40	(46)
	\$ (137)	\$ 169	\$ 61

Deferred taxes have also been adjusted in connection with the reallocation of the Sea-Pac purchase price described in Note 2.

An analysis of the differences between the effective tax rates and the Federal statutory rate is set forth below:

<i>(Amounts in thousands)</i>	1986		1985		1984	
	Amount	Percent	Amount	Percent	Amount	Percent
Federal tax at statutory rate	\$ 667	46.0	\$ 608	46.0	\$1,324	46.0
State taxes, net of Federal tax benefit	27	1.9	23	1.7	56	1.9
Investment tax credit-net	(70)	(4.8)	(279)	(21.1)	(155)	(5.4)
PAYSOP credit	(51)	(3.5)	(48)	(3.6)	(41)	(1.4)
Capital gains rate differential	(59)	(4.1)	(7)	(0.5)	(52)	(1.8)
Other-net	57	3.9	(48)	(3.7)	(73)	(2.5)
	\$ 571	39.4	\$ 249	18.8	\$1,059	36.8

6. Commitments

PGL leases certain branch facilities under "operating leases." Future minimum lease payments total \$928,000 and are payable as follows: 1987 \$270,000, 1988 \$209,000, 1989 \$168,000, 1990 \$72,000, 1991 \$38,000, and thereafter \$171,000. The lease obligations also extend to property taxes, insurance, and repairs and maintenance. Total lease expense charged to operations in the three fiscal years ended 1986 was \$636,000, \$647,000 and \$545,000, respectively.

7. Stock Purchase Plan and Stock Options

Stock Purchase Plan

PGL has an employee stock purchase plan for all employees with more than one year of service. Participation in the Plan is voluntary. Under the Plan, the stock purchase price is established as the lesser of 90% of the market value at the date of grant, or 100% of the market value at the date exercised, but not less than par value of \$1.00. As of January 31, 1986, 403 employees were eligible to participate in the Plan and 219 were enrolled.

A summary of the stock purchase plan activity for the three fiscal years ended 1986 follows:

<i>Fiscal Year Ended</i>	Shares Purchased	Average Price Per Share	Total
1986	34,949	\$6.92	\$241,900
1985	38,172	7.07	269,900
1984	16,692	9.21	153,800

At January 31, 1986, common stock reserved for issuance under this plan was 70,115 shares.

Stock Options

A total of 421,301 shares of common stock has been approved for issuance under the Incentive Stock Option Plan. The option price for common stock is the market value at the date of grant. The options are non-transferable and are exercisable over five years from the date of grant. As of January 31, 1986, options were granted and are outstanding to a total of 35 employees. Options for 164,984 shares of common stock were available for grant at January 31, 1986. A summary of the activity, for the three fiscal years ended 1986 follows:

	Number of Shares	Option Price		Market Price	
		Avg. Price Per Share	Total	Per Share	Total
Fiscal Year Ended 1986:					
Granted	61,000	\$ 7.38	\$ 449,875		
Exercised	1,082	7.63	8,253	\$ 8.63	\$9,332
Outstanding and Exercisable*	262,356	7.45	1,953,800		
Fiscal Year Ended 1985:					
Granted	81,500	8.00	652,250		
Exercised	2,122	7.54	16,003	9.13	19,375
Outstanding and Exercisable*	208,972	7.48	1,562,600		
Fiscal Year Ended 1984:					
Granted	35,500	10.00	355,000		
Exercised	8,986	7.32	65,753	10.91	98,004
Outstanding and Exercisable*	136,838	7.46	1,021,430		

*Adjusted for the 4% stock dividends distributed in October 1985

8. Major Customer

Approximately 7%, 8% and 10% of net sales were to a major building materials retailer in fiscal years ended 1986, 1985 and 1984, respectively.

**9. Unaudited Quarterly
Financial Results
(in thousands)**

<i>(Amounts in thousands except per share data)</i>	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net Sales:				
1986	\$32,975	\$37,510	\$39,941	\$30,347
1985	29,082	40,329	44,308	30,663
1984	25,740	33,536	37,259	24,508
Cost of Goods Sold:				
1986	\$27,037	\$31,210	\$32,991	\$24,907
1985	24,053	33,505	36,973	25,604
1984	21,264	27,998	31,269	19,916
Net Income:				
1986	\$ 11	\$ 213	\$ 625	\$ 29
1985	276	497	618	(319)
1984	142	554	757	366
Net Income Per Share:*				
1986	\$ —	\$.06	\$.16	\$.01
1985	.09	.13	.16	(.09)
1984	.07	.19	.25	.12

*Adjusted for Stock Dividends

Fourth quarter adjustments and revisions to quarterly estimates (amounts in thousands):

- 1986 — Contribution to profit sharing plans was \$84.
— Provision for income taxes increased because of higher than expected earnings and lower tax credits.
- 1985 — Write down of marginal assets of approximately \$700.
— Contribution to profit sharing plans was \$244.
— Provision for income taxes decreased because of higher than expected investment tax credits and credit for payroll stock ownership plan.
- 1984 — Contribution to the executive bonus and profit sharing plans was \$440.
— Provisions for income taxes decreased because of higher than expected investment tax credits, capital gains and credit for payroll stock ownership plan.

Auditors' Report

To the Stockholders of Palmer G. Lewis Co., Inc.:

We have examined the consolidated balance sheets of Palmer G. Lewis Co., Inc. (a Washington corporation) and subsidiaries as of January 31, 1986, and January 25, 1985 and the related consolidated statements of income, stockholders' equity and changes in financial position for each of the three years in the period ended January 31, 1986. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Palmer G. Lewis Co., Inc. and subsidiaries as of January 31, 1986, and January 25, 1985, and the results of their operations and the changes in their financial position for each of the three years in the period ended January 31, 1986, in conformity with generally accepted accounting principles applied on a consistent basis, after restatement of the 1985 financial statements for a change in the method of determining inventory costs of a subsidiary as discussed in Note 2.

Arthur Andersen & Co.

Seattle, Washington,
March 21, 1986.

Board of Directors

John N. Anderson†
*Vice Chairman and
Chief Executive Officer*
Palmer G. Lewis Co., Inc.
Auburn, Washington

Douglas S. Gamble*
*President and
Chief Executive Officer*
Pacific Gamble Robinson
Seattle, Washington

Gilbert R. Halley
Secretary-Treasurer
Palmer G. Lewis Co., Inc.
Auburn, Washington

J. Cutler Lewis
*Sales Manager,
Washington Region*
Palmer G. Lewis Co., Inc.
Auburn, Washington

Richard E. Lundgren
President
Palmer G. Lewis Co., Inc.
Auburn, Washington

Robert D. Peterson†
Chairman of the Board
Palmer G. Lewis Co., Inc.
Auburn, Washington

L.W. Wells*†
Executive Vice President
Winmar Company, Inc.
Seattle, Washington
(Financial Services)

Elliot K. Knutson*
*President and
Chief Executive Officer*
Washington Federal Savings
and Loan Association
of Seattle
Seattle, Washington
(Financial Services)

*Member of Audit Committee
†Member of Executive Committee

Annual Meeting

The annual meeting of share-
holders of Palmer G. Lewis
Co., Inc. will be held on
Thursday, May 15, 1986, at
2:00 p.m. in the Auditorium of
the Washington Athletic Club,
1325 6th, Seattle, Washington

Attorneys
Cartano, Botzer, Larson
and Birkholz
Seattle, Washington

Independent Public Accountants
Arthur Andersen & Co.
Seattle, Washington

**Registrar and
Transfer Agent**
Seattle-First National Bank
Seattle, Washington

Additional Information
A copy of the Company's Form
10-K report for the year ended
January 31, 1986 including
financial statements and
schedules, which will be filed
with the Securities and
Exchange Commission by May
1, 1986, is available to share-
holders, without charge, upon
written request to:

Gilbert R. Halley, Secretary
Palmer G. Lewis Co., Inc.
P.O. Box 1049
Auburn, Washington
98071-1049

Management and Service Center Locations

Corporate Headquarters
525 C Street N.W.
Auburn, WA 98071-1049
Palmer G. Lewis
Chairman of the Board
Emeritus

Robert D. Peterson
Chairman of the Board
John N. Anderson
*Vice Chairman and
Chief Executive Officer*
Richard E. Lundgren
President

Gilbert R. Halley
*Secretary-Treasurer and
Chief Financial Officer*
Lee R. Singer
*Assistant Treasurer &
Controller*

Louise W. Lewis
Assistant Secretary
John A. Fetch
Data Processing Manager
Perry W. Gorman
Personnel Manager

Building Material Division Headquarters

525 C Street N.W.
Auburn, WA 98071-1049
Ted C. Geocaris
Marketing Manager
Charles D. Lauber
*Manager Advertising &
Promotion*
Carl A. Liliequist
National Accounts Manager
W. Thomas Brynn
Credit Manager
Schell Harmon
Manager Inventory Control

**Washington and Alaska
Region Headquarters**
525 C Street N.W.
Auburn WA 98071-1049
Jim L. Capponi
Region Operations Manager
J. Cutler Lewis
Region Sales Manager
Kenneth L. Thompson
Branch Manager
Kenneth J. Gohrick
Inside Sales Manager
Joan E. Aliment
Credit Manager
Norman A. Larson
Trucking Supervisor
Donald R. Ray
Warehouse Supervisor

Anchorage Branch
5900 Arctic Blvd.
Anchorage, AK 99502
Craig M. Herrity
Manager

Bremerton Branch
Old Belfair Road
Bremerton, WA 98801
John C. Ruud
Manager

Marysville Branch
15102 35th Ave. N.E.
Marysville, WA 98011
Robert Dunn
Manager

Kenmore Branch
6820 N.E. 175th Street
Bothell, WA 98011
Jeffrey Z. Aiken
Manager

Spokane Branch
E. 4001 Broadway Avenue
Spokane, WA 99202
Robert E. Johnson
Manager

Wenatchee Sales Office
2717 Euclid Avenue
Wenatchee, WA 98801

Yakima Branch
2703 Fruitvale Blvd.
Yakima, WA 98902
L.L. (Pete) Briles
Manager

PGL Industrial Sales
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Auburn, WA 98071-1049
James L. Lang
Manager

**Oregon and Idaho
Region Headquarters**
8100 S.W. Hunziker Road
Tigard, OR 97723
Thomas V. Horstmann
Region Manager
Gerald L. Grider
Sales Manager
Margaret Taylor
Credit Manager

Medford Branch
2194 Sage Road
Medford, OR 97501
Harry Gerhard
Manager

Boise Branch
2255 Braniff Street
Boise, ID 83705
Raymond E. Ogden
Manager

**California and Nevada
Region Headquarters**
8435 - 24th Avenue
Sacramento, CA 95828
Earl W. Van Buskirk
Region Manager
Jerome W. Peterson
Sales Manager
N. Pat Olmstead
Administrative Manager
Anita Johnson
Credit Manager

Reno Branch
353 N. Park Street
Reno, NV 89504
Kenneth T. Ammon
Manager

Sea-Pac Sales, Inc. Headquarters

3800 1st Ave. S.
Seattle, WA 98134
John N. Anderson
President
Dennis R. Moore
Vice President
Floor Products Division
David H. Blakley
Vice President
Appliance Division
Lyman H. Black
Vice President
Operations
Melvin D. Knorr
Vice President
Sales Administration
Richard Barak
Credit Manager
R. Jeffrey Callison
Wood Flooring Sales Manager
Todd Eisinger
Accounting Manager
Ronald S. Monuszko
Carpet Sales Manager

Portland Branch
6060 North Cutter Circle
Portland, OR 97217-3935
Dale J. Griffiths
Manager

Spokane Branch
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Spokane, WA 99202
Bernice J. Beach
Manager

Billings Branch
505 N. 26th Street
Billings, MT 59101
Bernice J. Beach
Manager

Salt Lake City Branch
1011 West 2610 South
Salt Lake City, UT 84119
Suzanne Naujoks
Administrative Supervisor

Truck Service, Inc.

911 W. James Street
Kent, WA 98031
James V. Kelly
Manager

Cochrane Northwest Inc. Headquarters

3800 1st Avenue S.
Seattle, WA 98134
Mark F. Smith
*President and
General Manager*

Spokane Branch
N. 110 Greene Street
Spokane, WA 98202
Boyd C. Edelin
Manager

Tacoma Branch
1916 Marc Street
Tacoma, WA 98401
Richard L. Mercurio
Manager



Palmer G. Lewis Co., Inc.

- PGL Service Center
- Sea-Pac Sales, Inc.

Other Operations
Cochrane Northwest, Inc.
Tacoma
Spokane
Seattle

Truck Service Inc.
Kent

