

Primo Water Corp
Form 10-Q
November 07, 2014

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

FORM 10-Q
(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2014

OR

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

COMMISSION FILE NUMBER 001-34850
PRIMO WATER CORPORATION
(Exact name of registrant as specified in its charter)

Delaware 30-0278688
(State of incorporation) (I.R.S. Employer Identification No.)

104 Cambridge Plaza Drive, Winston-Salem, NC 27104
(Address of principal executive office) (Zip code)

(336) 331-4000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if smaller reporting company) Smaller reporting company

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of October 31, 2014, there were 24,530,299 shares of our Common Stock, par value \$0.001 per share, outstanding.

PRIMO WATER CORPORATION
FORM 10-Q
FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2014

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

PRIMO WATER CORPORATION
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (In thousands, except par value information)

	September 30, 2014 (unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash	\$ 707	\$ 394
Accounts receivable, net	8,920	7,614
Inventories	7,530	6,346
Prepaid expenses and other current assets	2,169	1,499
Total current assets	19,326	15,853
Bottles, net	4,121	4,104
Property and equipment, net	34,836	38,634
Intangible assets, net	9,849	10,872
Other assets	894	1,508
Total assets	\$ 69,026	\$ 70,971
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 11,547	\$ 10,943
Accrued expenses and other current liabilities	4,107	3,472
Current portion of capital leases and notes payable	103	16
Total current liabilities	15,757	14,431
Long-term debt, capital leases and notes payable, net of current portion	27,718	22,654
Liabilities of disposal group, net of current portion, and other long-term liabilities	2,328	2,330
Total liabilities	45,803	39,415
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value - 10,000 shares authorized, none issued and outstanding	–	–
Common stock, \$0.001 par value - 70,000 shares authorized, 24,530 and 24,076 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively	25	24
Additional paid-in capital	274,868	273,379
Common stock warrants	8,745	8,420
Accumulated deficit	(259,778)	(249,837)
Accumulated other comprehensive loss	(637)	(430)
Total stockholders' equity	23,223	31,556
Total liabilities and stockholders' equity	\$ 69,026	\$ 70,971

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share amounts)

	Three months ended September 30, 2014		2013		Nine months ended September 30, 2014		2013	
Net sales	\$26,374	\$25,519	\$76,756	\$71,696				
Operating costs and expenses:								
Cost of sales	18,777	18,936	56,210	53,924				
Selling, general and administrative expenses	4,089	3,812	12,348	11,585				
Non-recurring costs	54	96	2,773	190				
Depreciation and amortization	2,593	3,050	8,094	8,579				
Loss on disposal and impairment of property and equipment	58	61	1,081	137				
Total operating costs and expenses	25,571	25,955	80,506	74,415				
Income (loss) from operations	803	(436)	(3,750)	(2,719)				
Interest expense	537	1,138	5,790	3,359				
Income (loss) from continuing operations	266	(1,574)	(9,540)	(6,078)				
Loss from discontinued operations	(49)	(511)	(401)	(872)				
Net income (loss)	\$217	\$(2,085)	\$(9,941)	\$(6,950)				
Basic earnings (loss) per share:								
Income (loss) from continuing operations	\$0.01	\$(0.07)	\$(0.39)	\$(0.25)				
Loss from discontinued operations	(0.00)	(0.02)	(0.02)	(0.04)				
Net income (loss)	\$0.01	\$(0.09)	\$(0.41)	\$(0.29)				
Diluted earnings (loss) per share:								
Income (loss) from continuing operations	\$0.01	\$(0.07)	\$(0.39)	\$(0.25)				
Loss from discontinued operations	(0.00)	(0.02)	(0.02)	(0.04)				
Net income (loss)	\$0.01	\$(0.09)	\$(0.41)	\$(0.29)				
Weighted average shares used in computing earnings (loss) per share								
Basic	24,457	24,019	24,257	23,901				
Diluted	25,809	24,019	24,257	23,901				

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

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PRIMO WATER CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(Unaudited)

(In thousands)

	Three months ended September 30, 2014		Nine months ended September 30, 2014	
	2013		2013	
Net income (loss)	\$217	\$(2,085)	\$(9,941)	\$(6,950)
Other comprehensive income (loss):				
Foreign currency translation adjustments, net	(213)	113	(207)	(193)
Comprehensive income (loss)	\$4	\$(1,972)	\$(10,148)	\$(7,143)

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Nine months ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net loss	\$(9,941)	\$(6,950)
Less: Loss from discontinued operations	(401)	(872)
Loss from continuing operations	(9,540)	(6,078)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	8,094	8,579
Loss on disposal and impairment of property and equipment	1,081	137
Stock-based compensation expense	1,364	819
Non-cash interest expense	2,744	882
Issuance of DS Services' common stock warrant	589	–
Other	(162)	53
Changes in operating assets and liabilities:		
Accounts receivable	(1,074)	1,952
Inventories	(1,224)	715
Prepaid expenses and other assets	(87)	(211)
Accounts payable	882	3,870
Accrued expenses and other liabilities	466	(1,641)
Net cash provided by operating activities	3,133	9,077
Cash flows from investing activities:		
Purchases of property and equipment	(3,817)	(3,745)
Purchases of bottles, net of disposals	(1,993)	(1,904)
Proceeds from the sale of property and equipment	572	2
Additions to and acquisitions of intangible assets	(30)	(43)
Net cash used in investing activities	(5,268)	(5,690)
Cash flows from financing activities:		
Borrowings under Revolving Credit Facilities	40,553	68,062
Payments under Revolving Credit Facilities	(36,198)	(73,899)
Borrowings under Term loans	22,500	3,000
Payments under Term loans	(23,499)	–
Note payable and capital lease payments	(113)	(11)
Debt issuance costs	(625)	(689)
Stock option and employee stock purchase activity, net	119	82
Net cash provided by (used in) financing activities	2,737	(3,455)
Cash (used in) provided by operating activities of discontinued operations	(231)	189
Effect of exchange rate changes on cash	(58)	(47)
Net increase in cash	313	74
Cash, beginning of year	394	234
Cash, end of period	\$707	\$308

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

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PRIMO WATER CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(In thousands, except per share amounts)

1. Description of Business and Significant Accounting Policies

Business

Primo Water Corporation (together with its consolidated subsidiaries, “Primo,” “we,” “our,” “us”) is a leading provider of multi-gallon purified bottled water, self-service refill water and water dispensers sold through major retailers in the United States and Canada.

Unaudited Interim Financial Information

The accompanying interim condensed consolidated financial statements have been prepared in accordance with our accounting practices described in our audited consolidated financial statements for the year ended December 31, 2013, and are unaudited. In the opinion of management, the unaudited interim condensed consolidated financial statements included herein contain all adjustments necessary to present fairly our financial position, results of operations and cash flows for the periods indicated. Such adjustments, other than nonrecurring adjustments that have been separately disclosed, are of a normal, recurring nature. The operating results for interim periods are not necessarily indicative of results to be expected for a full year or future interim periods. The unaudited interim condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes as of and for the year ended December 31, 2013. The accompanying interim condensed consolidated financial statements are presented in accordance with the rules and regulations of the Securities and Exchange Commission and, accordingly, do not include all the disclosures required by generally accepted accounting principles in the United States (“U.S. GAAP”) with respect to annual financial statements. Certain significant accounting policies, in addition to those described below, are summarized in our 2013 Form 10-K. Certain 2013 amounts in the accompanying interim condensed consolidated financial statements have been reclassified to conform to the 2014 presentation, with no effect on stockholders’ equity or net loss as previously presented.

Discontinued Operations

As described in Note 2, during 2012, we committed to a plan to sell the assets of the sparkling beverage appliances, flavorings, CO2 cylinders and accessories business sold under the Flavorstation brand (the “Disposal Group”). We determined that the Disposal Group meets the criteria for classification as discontinued operations. As a result, the results of operations and financial position of the Disposal Group for the current and prior periods are reflected as discontinued operations.

DS Services Agreement

On November 12, 2013, we entered into a strategic alliance agreement (the “DS Services Agreement”) with DS Services of America, Inc. (“DS Services”) pursuant to which DS Services will act as the primary bottler and distributor and provider of exchange and supply services for the exchange business in the United States. Pursuant to the agreement, DS Services has become our bottler and distributor in certain territories during 2014. DS Services will become our primary bottler and distributor in other territories as existing distributor arrangements expire or are terminated. We have completed the transition of the bottling, distributing and supply services for our exchange business to DS Services. We expect the transition of DS Services retail customers to Primo to be completed by December 31, 2015.

Revenue Recognition

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Revenue is recognized for the sale of multi-gallon purified bottled water upon either the delivery of inventory to the retail store or the purchase by the consumer. Revenue is either recognized as an exchange transaction (where a discount is provided on the purchase of a multi-gallon bottle of purified water for the return of an empty multi-gallon bottle) or a non-exchange transaction. Revenues on exchange transactions are recognized net of the exchange discount. Self-service refill water revenue is recognized as the water is filtered, which is measured by the water dispensing equipment meter.

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Revenue is recognized for the sale of our water dispenser products when title is transferred to our retail customers. We have no contractual obligation to accept returns nor do we guarantee sales. However, we will at times accept returns or issue credits for manufacturer defects or for units that were damaged in transit. Revenues 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 condensed consolidated statements of operations. With the purchase of certain of our water dispensers we include a coupon for a free multi-gallon bottle of purified water. No revenue is recognized with respect to the redemption of the coupon for a free multi-gallon bottle of water and the estimated cost of the multi-gallon bottle of purified water is included in cost of sales.

Accounts Receivable

All trade accounts receivable are due from customers located within the United States and Canada. We maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. Accounts receivable, net included allowances for doubtful accounts of \$110 and \$321 at September 30, 2014 and December 31, 2013, respectively. 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.

Intangible Assets

We classify intangible assets into two categories: (1) intangible assets with definite lives subject to amortization and (2) intangible assets with indefinite lives not subject to amortization. We determine the useful lives of our identifiable intangible assets after considering the specific facts and circumstances related to each intangible asset. Factors we consider when determining useful lives include the contractual term of any agreement related to the asset, the historical performance of the asset, our long-term strategy for using the asset, any laws or other local regulations which could impact the useful life of the asset, and other economic factors, including competition and specific market conditions. Intangible assets that are deemed to have definite lives are amortized, primarily on a straight-line basis, over their useful lives. Intangible assets that are deemed to have indefinite lives are tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired.

Concentrations of Risk

Our principal financial instruments subject to potential concentration of credit risk are cash, trade receivables and accounts payable. We invest our funds in a highly rated institution and believe the financial risk associated with cash in excess of federally insured amounts is minimal.

We perform ongoing credit evaluations of our customers' financial condition and maintain allowances for doubtful accounts that we believe are sufficient to provide for losses that may be sustained on realization of accounts receivable.

Basic and Diluted Earnings (Loss) Per Share

Earnings (loss) per share has been computed using the weighted average number of shares of common stock outstanding during each period. Diluted amounts per share include the dilutive impact, if any, of our outstanding potential common shares, such as options, unvested shares of restricted stock, restricted stock units and warrants. Potential common shares that are anti-dilutive are excluded from the calculation of diluted earnings (loss) per share.

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Cumulative Translation Adjustment and Foreign Currency Transactions

The local currency of our operations in Canada is considered to be the functional currency. Assets and liabilities of the Canada subsidiary are translated into U. S. dollars using the exchange rates in effect at the balance sheet date. Results of operations are translated using the average exchange rate prevailing throughout the period. The effects of unrealized exchange rate fluctuations on translating foreign currency assets and liabilities into U. S. dollars are accumulated as the cumulative translation adjustment included in accumulated other comprehensive loss in the condensed consolidated statements of comprehensive loss. With the exception of transaction gains and losses on certain intercompany balances which we have determined are of a long-term investment nature, realized gains and losses on foreign currency transactions are included in the condensed consolidated statements of operations. At September 30, 2014 and December 31, 2013, accumulated other comprehensive loss balances of \$637 and \$430, respectively, were related to unrealized foreign currency translation adjustments and transaction gains and losses on certain intercompany balances.

Non-recurring costs

Transactions that are unusual in nature or which occur infrequently, but not both, are reported as non-recurring costs on our condensed consolidated statements of operations. Non-recurring costs consist primarily of transition and other expenses associated with the DS Services Agreement as well as other legal, severance and restructuring-related expenses.

Recent Accounting Pronouncements

In May 2014, the FASB issued updated guidance which supersedes existing revenue recognition requirements in U.S. GAAP. The updated guidance requires that an entity recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, the guidance establishes a five-step approach for the recognition of revenue. The update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. We are currently evaluating the impact of adopting this guidance on our consolidated financial statements.

In April 2014, the FASB issued updated guidance changing the requirements for reporting discontinued operations. The updated guidance requires that a disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results when the component or components meet the criteria to be classified as held for sale, is disposed of by sale or is disposed of other than by sale. The updated guidance also requires additional disclosures about discontinued operations. The updates are effective for disposals (or classifications as held for sale) of components of an entity that occur within annual periods beginning on or after December 15, 2014. The updates are not applicable to a component or components that are classified as held for sale before the effective date. The amendments are not expected to have a significant impact on our consolidated financial statements.

In July 2013, the FASB issued updated guidance requiring that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented as a liability and should not be combined with deferred tax assets. We have adopted this updated guidance effective January 1, 2014. The adoption did not have a significant

impact on our consolidated financial statements.

2. Discontinued Operations

During 2012, we committed to a plan to sell the assets of the Disposal Group, which includes sparkling beverage appliances, flavorings, CO₂ cylinders and accessories sold under the Flavorstation brand as well as the Omnifrio Single-Serve Business and initiated an active program to execute this plan. In addition, we determined that the Disposal Group met all of the criteria for classification as discontinued operations. As a result, current and prior year amounts and disclosures reflect these operations as discontinued operations.

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The assets and liabilities of the Disposal Group classified as held for sale and reported within prepaid expenses and other current assets, accrued expenses and other current liabilities, and liabilities of disposal group, net of current portion, and other long-term liabilities on our condensed consolidated balance sheets, were as follows:

	September 30, 2014	December 31, 2013
Current assets of disposal group held for sale		
Accounts receivable, net	\$ –	\$ 15
Inventories	–	200
Prepaid expenses and other current assets	4	10
	\$ 4	\$ 225
Current liabilities of disposal group held for sale		
Accounts payable	\$ 14	\$ 39
Accrued expenses and other current liabilities	27	53
	\$ 41	\$ 92
Liabilities of disposal group held for sale, net of current portion		
Other long-term liabilities	\$ 2,000	\$ 2,000
	\$ 2,000	\$ 2,000

The net sales and operating results classified as discontinued operations were as follows:

	Three months ended September 30, 2014		Nine months ended September 30, 2013	
Net sales	\$ 1	\$ 647	\$ 169	\$ 2,651
Operating costs and expenses:				
Cost of sales	–	1,009	262	3,154
Selling, general and administrative	50	149	308	369
Total operating costs and expenses	50	1,158	570	3,523
Loss from discontinued operations	\$(49)	\$(511)	\$(401)	\$(872)

3. Property and Equipment

Property and equipment is summarized as follows at September 30, 2014 and December 31, 2013:

	September 30, 2014	December 31, 2013
Leasehold improvements	\$ 90	\$ 87
Machinery and equipment	6,935	8,347
Vending equipment	26,418	24,083
Racks and display panels	28,621	33,562
Office furniture and equipment	234	234

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Software and computer equipment	4,088	3,972
Vehicles under capital leases	405	–
Equipment not in service	662	1,525
	67,453	71,810
Less accumulated depreciation and amortization	(32,617)	(33,176)
	\$ 34,836	\$ 38,634

During the second quarter of 2014, we entered into an arrangement to sell or otherwise dispose of certain racks and machinery in exchange for cash proceeds of \$1,212. The racks and machinery disposed of had a gross carrying value of \$5,392 and accumulated depreciation of \$(3,677) reported within property and equipment, net on our condensed consolidated balance sheets. The expected total sales proceeds, less amounts collected during the third quarter of 2014, is presented as a receivable in prepaid expenses and other current assets on our condensed consolidated balance sheets at September 30, 2014. The disposals resulted in a loss of \$503 which is reported within loss on disposal and impairment of property and equipment on our condensed consolidated statements of operations for the nine months ended September 30, 2014.

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4. Debt, Capital Leases and Notes Payable

Long-term debt, capital leases and notes payable are summarized as follows:

	September 30, 2014	December 31, 2013
Revolving Credit Facility	\$ 7,500	\$ –
Term Notes	20,000	–
Prior Senior Revolving Credit Facility	–	3,145
Prior Term Loans, net of discount	–	19,496
Notes payable and capital leases	321	29
	27,821	22,670
Less current portion	(103)	(16)
Long-term debt, notes payable and capital leases, net of current portion	\$ 27,718	\$ 22,654

On June 20, 2014, we entered into a credit facility that provides up to \$35,000 in secured indebtedness and consists of a \$15,000 revolving credit facility (the “Revolving Credit Facility”) and \$20,000 in term notes (the “Term Notes”). We repaid outstanding prior term loans and borrowings outstanding on the prior senior revolving credit facility upon entering into our existing credit facility. The Revolving Credit Facility terminates on June 20, 2019 with all outstanding borrowings and accrued interest to be repaid on such date and the Term Notes mature on June 20, 2021 with all outstanding indebtedness and accrued interest to be repaid on such date. The credit facility is secured on a first priority basis by substantially all of our assets.

Interest on outstanding amounts owed under the Term Notes is payable quarterly at the rate of 7.8%. Principal payments under the Term Notes are payable in five annual \$4,000 installments beginning on June 20, 2017. Total costs associated with the Term Notes were \$336, which have been capitalized and are being amortized as part of interest expense over the term of the Term Notes.

Interest on outstanding borrowings under the Revolving Credit Facility is payable at our option at either (i) the Base Rate, defined as the greater of the Prime Rate, the Federal Funds Effective Rate plus 0.50% or the LIBOR for a three-month interest period plus 1.0%, plus in each such case a margin of 3.25% or (ii) a one-, two-, three- or six-month LIBOR rate, plus a margin of 4.25%. We are required to pay a commitment fee of 0.50% on the unused amount of the commitment under the Revolving Credit Facility. Total costs associated with the Revolving Credit Facility were \$211, which have been capitalized and are being amortized as part of interest expense over the term of the Revolving Credit Facility. As of September 30, 2014, we had \$7,500 in outstanding borrowings at a weighted-average interest rate of 4.41% and our remaining availability was \$7,500 under the Revolving Credit Facility.

Our new credit facility contains a number of affirmative and restrictive covenants (including limitations on dissolutions, sales of assets, investments, and indebtedness and liens) and contains the following financial covenants: (i) a ratio of consolidated total indebtedness to adjusted EBITDA of no more than 3.00 to 1.00 as of the last day of each month (measured on a trailing four-quarter basis), declining to 2.75 on October 31, 2015 and thereafter, (ii) a consolidated tangible net worth requirement measured at the end of each month of no less than \$11,000 plus 50% of consolidated net income on a cumulative basis for each succeeding fiscal quarter, commencing with the quarter ended June 30, 2014 (net losses are disregarded), and (iii) a ratio of adjusted EBITDA to consolidated fixed charges of no less than 0.80 to 1.00 as of the last day of each quarter (measured on a trailing four-quarter basis), increasing to 0.90 on December 31, 2014, and increasing to 1.00 on March 31, 2015 and thereafter. At September 30, 2014 we were in compliance with all covenants with: (i) a consolidated total indebtedness to adjusted EBITDA ratio of 2.40 to 1.00, (ii)

consolidated tangible net worth of \$13,373 compared to the minimum of \$11,109 and (iii) an adjusted EBITDA to consolidated fixed charges ratio of 0.99.

In connection with the closing of the new credit facility, we amortized the remaining \$883 in deferred loan costs, \$583 in debt discount and \$677 in original issue discount related to the prior senior revolving credit facility and prior term loans. Interest expense, inclusive of the write-off described above, related to deferred loan cost amortization, debt discount and original issue discount amortization for the prior senior revolving credit facility and the prior term loans totaled \$2,718 for the nine months ended September 30, 2014. In addition, we paid a \$705 early payment penalty associated with the prior term loans.

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The prior term loans were accompanied by detachable warrants to purchase 1,731 shares of our common stock, including detachable warrants to purchase 131 shares of our common stock received by five of our current directors or stockholders (the “Insider Participants”). The Insider Participants include Billy D. Prim, Malcolm McQuilkin and Jack C. Kilgore, all three of whom are current directors of Primo. The warrants issued to Insider Participants are exercisable at an exercise price of \$2.30 per share and expire April 30, 2020. The warrants issued to non-Insider Participants are exercisable at an exercise price of \$1.20 per share and expire also April 30, 2020. During the nine months ended September 30, 2014, warrants to purchase 300 shares of our common stock were exercised by non-Insider Participants, resulting in net share settlement of 219 shares.

Interest expense includes financing costs for a supplier of \$0 and \$217 for the three months ended September 30, 2014 and 2013, respectively, and \$305 and \$553 for the nine months ended September 30, 2014 and 2013, respectively. During the second and third quarter of 2014, we discontinued the financing arrangement with the resumption of normal terms with the supplier.

5. Stockholders’ Equity and Stock-Based Compensation

As part of the DS Services Agreement, on January 1, 2014, we granted DS Services a warrant to purchase 475 shares of our common stock. The warrant is immediately exercisable at an exercise price of \$3.04 per share and expires January 1, 2021. The warrant’s fair value of \$589 was determined using the Black-Scholes pricing model and was recorded in common stock warrants on our condensed consolidated balance sheets and in non-recurring costs on our condensed consolidated statements of operations.

For the three and nine months ended September 30, 2014, we issued 72,972 and 219,238 shares of our common stock, respectively, upon partial cashless exercises of outstanding common stock purchase warrants with an exercise price of \$1.20 per share originally issued to Comvest Capital II, L.P. on April 30, 2012.

Compensation expense related to stock-based compensation plans was \$467 and \$196 for the three months ended September 30, 2014 and 2013, respectively, and \$1,364 and \$819 for the nine months ended September 30, 2014 and 2013, respectively. Stock-based compensation is included in selling, general and administrative expenses in the condensed consolidated statements of operations.

6. Commitments and Contingencies

Florida Concentrates Suit

On October 16, 2012, Primo was served with the Summons and Complaint in a suit filed in the Florida state courts on September 26, 2012. Plaintiffs in the suit are Florida Concentrates International, LLC (a Florida limited liability company), Florida Sparkling DS, LLC (a Florida limited liability company), and Didier Hardy (a Florida resident and apparently the principal of the LLC plaintiffs). Also named as defendants are Susan and Scott Ballantyne (alleged to be Florida residents) and SDS-IC. The suit was filed in the Circuit Court for the Twentieth Judicial District (Collier County, Florida). Plaintiffs’ allegations include breach of contract, misappropriation of trade secrets and certain additional claims and plaintiffs seek monetary damages. We filed a motion to dismiss all claims, which was granted in part and denied in part on June 21, 2013. Plaintiffs filed an amended complaint on July 10, 2013 to which we responded on August 28, 2013. We do not believe that the suit has any merit whatsoever, and plan to vigorously contest and defend against it.

Omnifrio Single-Serve Beverage Business

Deferred purchase price payments totaling \$2,000 were included within other long-term liabilities on the condensed consolidated balance sheets as of September 30, 2014 and December 31, 2013, respectively. These payments were

related to the April 11, 2011 acquisition of certain intellectual property and other assets from the seller, Omnifrio Beverage Company LLC (“Omnifrio”). On July 19, 2013, we entered into a conditional settlement and release agreement with Omnifrio and certain other parties pursuant to which we agreed to, among other things, use commercially reasonable efforts to sell the assets purchased from Omnifrio in April 2011 and to provide Omnifrio certain amounts of the proceeds of any such sale in exchange for Omnifrio agreeing to release us from any claims related to the milestone payments included in our original purchase agreement with Omnifrio and, upon the sale of such assets, to release us from any claims related to the deferred purchase price payments included in such agreement. On July 19, 2014, the conditional settlement and release agreement was amended to extend its term through October 17, 2014. On October 18, 2014, the conditional settlement and release agreement was further amended to extend its term through April 17, 2015.

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Prism Arbitration

On August 5, 2014, Primo Distribution, LLC (also known as Prism Distribution) initiated an arbitration proceeding against us, claiming less than \$1,000 in damages for alleged breach of contract. The arbitration was filed with the American Arbitration Association. We do not believe that the claim has any merit and plan to vigorously contest and defend against it.

Texas Regional Operator Litigation

On August 8, 2014, a lawsuit was commenced against us by our regional operators in the State of Texas, Artesia Springs, LLC, HOD Enterprises, L.P., and BBB Water, Inc. (the "ROs"). DS Services is also named as a defendant in the suit. The suit was filed in the 166th Judicial District Court of Bexar County, Texas, and was served upon us on August 25, 2014. We removed the suit to the United States District Court for the Western District of Texas on September 5, 2014. The claims alleged against us in the suit are breach of contract, conspiracy and fraud, and the ROs seek unspecified monetary damages as well as injunctive relief. We do not believe that the claim has any merit and plan to vigorously contest and defend against it. We responded to the complaint on September 24, 2014 by filing a motion to dismiss, to compel alternative dispute resolution, and to stay proceedings.

Sales Tax

We routinely purchase equipment for use in operations from various vendors. These purchases are subject to sales tax depending on the equipment type and local sales tax regulations; however, we believe certain vendors have not assessed the appropriate sales tax. For purchases that are subject to sales tax in which we believe the vendor did not assess the appropriate amount, we accrue an estimate of the sales tax liability we ultimately expect to pay.

Other Contingencies

From time to time, we are involved in various claims and legal actions that arise in the normal course of business. Management believes that the outcome of such legal actions will not have a significant adverse effect on our financial position, results of operations or cash flows.

7. Income Taxes

We have established a full valuation allowance for our deferred tax assets that are not expected to be realized. We have incurred losses since inception and in all reporting periods prior to the third quarter of 2014. We expect to report a loss for the full year ended December 31, 2014. Therefore, for the three and nine months ended September 30, 2014 and 2013, there was no income tax expense or benefit.

Section 382 of the U.S. Internal Revenue Code imposes an annual limitation on the amount of net operating loss carryforwards that might be used to offset taxable income when a corporation has undergone significant changes in stock ownership. We believe our prior ownership changes have created an annual limit, imposed by Section 382, on the amount of net operating loss we can utilize in a given year, however, we believe the annual limit is such that we will be able to utilize our net operating loss carryforwards during their respective carryforward periods.

8. Fair Value Measurements

Fair value rules currently apply to all financial assets and liabilities and for certain nonfinancial assets and liabilities that are required to be recognized or disclosed at fair value. For this purpose, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs

and minimize the use of unobservable inputs.

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U.S. GAAP establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include:

Level 1 — quoted prices in active markets for identical assets and liabilities.

Level 2 — observable inputs other than quoted prices in active markets for identical assets and liabilities.

Level 3 — unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions.

At September 30, 2014, we reported barter credits in prepaid and other current assets and in other assets on our condensed consolidated balance sheets at their estimated fair values of \$10 and \$187, respectively, on a nonrecurring basis. These amounts were unchanged from December 31, 2013. The barter credits are measured at fair value using significant unobservable inputs, primarily based on the fair value of the products and services to be received upon exchange (Level 3 inputs).

The carrying amounts of our financial instruments, which include cash, accounts receivable, net, accounts payable, and accrued expenses and other current liabilities, approximate their fair values due to their short maturities. Assets and liabilities of the Disposal Group classified as held for sale and reported within prepaid expenses and other current assets, accrued expenses and other current liabilities and liabilities of disposal group, net of current portion, and other long-term liabilities on our condensed consolidated balance sheets are presented at their carrying value, which approximates their fair value. Based on borrowing rates currently available to us for loans with similar terms, the carrying value of debt, capital leases and notes payable approximates fair value.

9. Earnings (Loss) Per Share

The following table sets forth the calculations of basic and diluted earnings (loss) per share:

	Three months ended September 30, 2014		Nine months ended September 30, 2013	
Basic:				
Income (loss) from continuing operations	\$266	\$(1,574)	\$(9,540)	\$(6,078)
Loss from discontinued operations	(49)	(511)	(401)	(872)
Net income (loss)	\$217	\$(2,085)		