

KATY INDUSTRIES INC  
Form 10-Q  
November 15, 2010

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United States  
Securities and Exchange Commission  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended: October 1, 2010

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 001-05558

Katy Industries, Inc.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation or  
organization)

75-1277589  
(I.R.S. Employer Identification No.)

305 Rock Industrial Park Drive, Bridgeton, Missouri 63044  
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (314) 656-4321

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 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.

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

Accelerated filer   
Smaller reporting  
company

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

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

| Class                       | Outstanding at October 31, 2010 |
|-----------------------------|---------------------------------|
| Common Stock, \$1 Par Value | 7,951,176 Shares                |

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

KATY INDUSTRIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
AS OF OCTOBER 1, 2010 (UNAUDITED) AND DECEMBER 31, 2009  
(Amounts in Thousands)

## ASSETS

|                                    | October 1,<br>2010 | December<br>31,<br>2009 |
|------------------------------------|--------------------|-------------------------|
| <b>CURRENT ASSETS:</b>             |                    |                         |
| Cash                               | \$608              | \$747                   |
| Accounts receivable, net           | 15,868             | 12,831                  |
| Inventories, net                   | 16,683             | 16,195                  |
| Other current assets               | 1,720              | 1,144                   |
| <b>Total current assets</b>        | <b>34,879</b>      | <b>30,917</b>           |
| <b>OTHER ASSETS:</b>               |                    |                         |
| Goodwill                           | 665                | 665                     |
| Intangibles, net                   | 3,632              | 4,010                   |
| Other                              | 3,087              | 2,830                   |
| <b>Total other assets</b>          | <b>7,384</b>       | <b>7,505</b>            |
| <b>PROPERTY AND EQUIPMENT</b>      |                    |                         |
| Land and improvements              | 336                | 336                     |
| Buildings and improvements         | 9,753              | 9,514                   |
| Machinery and equipment            | 91,494             | 91,585                  |
|                                    | 101,583            | 101,435                 |
| Less - Accumulated depreciation    | (77,594 )          | (73,417 )               |
| <b>Property and equipment, net</b> | <b>23,989</b>      | <b>28,018</b>           |
| <b>Total assets</b>                | <b>\$66,252</b>    | <b>\$66,440</b>         |

See Notes to Condensed Consolidated Financial Statements.



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KATY INDUSTRIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
AS OF OCTOBER 1, 2010 (UNAUDITED) AND DECEMBER 31, 2009  
(Amounts in Thousands, Except Share Data)

LIABILITIES AND STOCKHOLDERS' EQUITY

|   | October 1,<br>2010 | December<br>31,<br>2009 |
|---|--------------------|-------------------------|
| <b>CURRENT LIABILITIES:</b>   |                    |                         |
| Accounts payable  | \$11,701           | \$10,476                |
| Book overdraft  | 367                | 1,285                   |
| Accrued compensation  | 2,348              | 2,614                   |
| Accrued expenses  | 11,724             | 14,252                  |
| Current maturities of long-term debt  | 1,138              | 6,899                   |
| Revolving credit agreement  | 14,993             | 8,856                   |
| <b>Total current liabilities</b>  | <b>42,271</b>      | <b>44,382</b>           |
| <b>LONG-TERM DEBT, less current maturities</b>  | <b>6,644</b>       | <b>-</b>                |
| <b>OTHER LIABILITIES</b>  | <b>6,030</b>       | <b>8,739</b>            |
| <b>Total liabilities</b>  | <b>54,945</b>      | <b>53,121</b>           |
| <b>COMMITMENTS AND CONTINGENCIES (Note 9)</b>   |                    |                         |
| <b>STOCKHOLDERS' EQUITY</b>   |                    |                         |
| 15% Convertible preferred stock, \$100 par value; authorized 1,200,000 shares; issued and outstanding 1,131,551 shares; liquidation value \$113,155 | 108,256            | 108,256                 |
| Common stock, \$1 par value; authorized 35,000,000 shares; issued 9,822,304 shares  | 9,822              | 9,822                   |
| Additional paid-in capital  | 27,419             | 27,246                  |
| Accumulated other comprehensive loss  | (2,000 )           | (2,053 )                |
| Accumulated deficit   | (110,753 )         | (108,515 )              |
| Treasury stock, at cost, 1,871,128 shares   | (21,437 )          | (21,437 )               |
| <b>Total stockholders' equity</b>   | <b>11,307</b>      | <b>13,319</b>           |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$66,252</b>    | <b>\$66,440</b>         |

See Notes to Condensed Consolidated Financial Statements.

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KATY INDUSTRIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE THREE AND NINE MONTHS ENDED OCTOBER 1, 2010 AND OCTOBER 2, 2009  
(Amounts in Thousands, Except Per Share Data)  
(Unaudited)

|   | Three Months Ended |                    | Nine Months Ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | October 1,<br>2010 | October 2,<br>2009 | October 1,<br>2010 | October 2,<br>2009 |
| Net sales   | \$37,584           | \$37,612           | \$110,057          | \$110,380          |
| Cost of goods sold                                      | 33,864             | 32,501             | 96,768             | 93,944             |
| Gross profit  | 3,720              | 5,111              | 13,289             | 16,436             |
| Selling, general and administrative expenses            | 4,453              | 5,695              | 16,427             | 19,818             |
| Severance, restructuring and related charges            | 747                | -                  | 1,002              | -                  |
| (Gain) loss on sale or disposal of assets               | (189 )             | 49                 | (189 )             | 61                 |
| Operating loss  | (1,291 )           | (633 )             | (3,951 )           | (3,443 )           |
| Interest expense  | (389 )             | (281 )             | (1,254 )           | (873 )             |
| Other, net  | 106                | 118                | 2,466              | 123                |
| Loss before income tax (provision) benefit              | (1,574 )           | (796 )             | (2,739 )           | (4,193 )           |
| Income tax (provision) benefit                          | (11 )              | (14 )              | 501                | 421                |
| Net loss  | \$(1,585 )         | \$(810 )           | \$(2,238 )         | \$(3,772 )         |
| Net loss per share of common stock - Basic and diluted: | \$(0.20 )          | \$(0.10 )          | \$(0.28 )          | \$(0.47 )          |
| Weighted average common shares outstanding:             |                    |                    |                    |                    |
| Basic and diluted                                       | 7,951              | 7,951              | 7,951              | 7,951              |

See Notes to Condensed Consolidated Financial Statements.



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KATY INDUSTRIES, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED OCTOBER 1, 2010 AND OCTOBER 2, 2009  
(Amounts in Thousands)  
(Unaudited)

|   | October 1,<br>2010 | October 2,<br>2009 |
|---|--------------------|--------------------|
| Cash flows from operating activities:               |                    |                    |
| Net loss  | \$(2,238 )         | \$(3,772 )         |
| Depreciation  | 4,636              | 4,691              |
| Amortization of intangible assets                   | 406                | 372                |
| Write-off and amortization of debt issuance costs   | 411                | 287                |
| Stock-based compensation                            | (110 )             | 372                |
| (Gain) loss on sale or disposal of assets           | (189 )             | 61                 |
| Gain on settlement of existing obligation           | (2,100 )           | -                  |
|   | 816                | 2,011              |
| Changes in operating assets and liabilities:        |                    |                    |
| Accounts receivable                                 | (3,022 )           | (1,626 )           |
| Inventories   | (455 )             | 3,745              |
| Other assets  | (440 )             | 1,103              |
| Accounts payable                                    | 1,213              | (731 )             |
| Accrued expenses                                    | (506 )             | 670                |
| Other   | (2,625 )           | (1,635 )           |
|   | (5,835 )           | 1,526              |
| Net cash (used in) provided by operating activities | (5,019 )           | 3,537              |
| Cash flows from investing activities:               |                    |                    |
| Capital expenditures                                | (773 )             | (1,537 )           |
| Proceeds from sale of assets                        | 128                | 2                  |
| Net cash used in investing activities               | (645 )             | (1,535 )           |
| Cash flows from financing activities:               |                    |                    |
| Net borrowings on revolving loans                   | 6,114              | 659                |
| Decrease in book overdraft                          | (918 )             | (1,200 )           |
| Proceeds from term loans                            | 8,182              | -                  |
| Repayments of term loans                            | (7,299 )           | (1,131 )           |
| Direct costs associated with debt facilities        | (597 )             | -                  |
| Net cash provided by (used in) financing activities | 5,482              | (1,672 )           |
| Effect of exchange rate changes on cash             | 43                 | (118 )             |
| Net (decrease) increase in cash                     | (139 )             | 212                |
| Cash, beginning of period                           | 747                | 683                |
| Cash, end of period                                 | \$608              | \$895              |

See Notes to Condensed Consolidated Financial Statements.



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KATY INDUSTRIES, INC. AND SUBSIDIARIES  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

Note 1. SIGNIFICANT ACCOUNTING POLICIES

**Consolidation Policy and Basis of Presentation** – The condensed consolidated financial statements include the accounts of Katy Industries, Inc. and subsidiaries in which it has a greater than 50% voting interest or significant influence, collectively “Katy” or the “Company”. All significant intercompany accounts, profits and transactions have been eliminated in consolidation. The Condensed Consolidated Balance Sheet at October 1, 2010 and the related Condensed Consolidated Statements of Operations for the three and nine months ended October 1, 2010 and October 2, 2009 and Cash Flows for the nine months ended October 1, 2010 and October 2, 2009 have been prepared without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial condition, results of operations and cash flows of the Company for the interim periods. Interim results may not be indicative of results to be realized for the entire year. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto, together with management’s discussion and analysis of financial condition and results of operations, contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2009. The Condensed Consolidated Balance Sheet as of December 31, 2009 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States (“GAAP”).

**Fiscal Year** – The Company operates and reports using a 4-4-5 fiscal year which always ends on December 31. As a result, December and January do not typically consist of five and four weeks, respectively. The three and nine months ended October 1, 2010 consisted of 63 shipping days and 191 shipping days, respectively, and the three and nine months ended October 2, 2009 consisted of 64 shipping days and 192 shipping days, respectively.

**Use of Estimates** – The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Inventories** – The components of inventories are as follows (amounts in thousands):

|                    | October<br>1,<br>2010 | December<br>31,<br>2009 |
|--------------------|-----------------------|-------------------------|
| Raw materials      | \$ 9,145              | \$ 10,240               |
| Finished goods     | 13,117                | 10,744                  |
| Inventory reserves | (1,391 )              | (1,315 )                |
| LIFO reserve       | (4,188 )              | (3,474 )                |
|                    | \$ 16,683             | \$ 16,195               |

At October 1, 2010 and December 31, 2009, approximately 63% and 56%, respectively, of Katy’s inventories were accounted for using the last-in, first-out (“LIFO”) method of costing, while the remaining inventories were accounted for using the first-in, first-out (“FIFO”) method. Current cost, as determined using the FIFO method, exceeded LIFO cost by \$4.2 million and \$3.5 million at October 1, 2010 and December 31, 2009, respectively.

Share-Based Payment – Compensation cost recognized during the three and nine months ended October 1, 2010 and October 2, 2009 includes: a) compensation cost for all stock options granted subsequent to January 1, 2006, based on the grant date fair value amortized over the options' vesting period and b) compensation cost for outstanding stock appreciation rights ("SARs") as of October 1, 2010 and October 2, 2009 based on the October 1, 2010 and October 2, 2009 fair value, respectively.

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Compensation expense (income) is included in selling, general and administrative expense in the Condensed Consolidated Statements of Operations. The components of compensation expense (income) are as follows (amounts in thousands):

|   | Three Months Ended |         | Nine Months Ended |         |
|---|--------------------|---------|-------------------|---------|
|   | October            | October | October           | October |
|   | 1,                 | 2,      | 1,                | 2,      |
|   | 2010               | 2009    | 2010              | 2009    |
| Stock option expense                      | \$ 42              | \$ 98   | \$ 173            | \$ 372  |
| Stock appreciation right (income) expense | (177 )             | 8       | (283 )            | -       |
|   | \$ (135 )          | \$ 106  | \$ (110 )         | \$ 372  |

The fair value of stock options is estimated at the date of grant using a Black-Scholes option pricing model. As the Company does not have sufficient historical exercise data to provide a basis for estimating the expected term, the Company uses the simplified method for estimating the expected term by averaging the minimum and maximum lives expected for each award. In addition, the Company estimated volatility by considering its historical stock volatility over a term comparable to the remaining expected life of each award. The risk-free interest rate is the current yield available on U.S. treasury issues with a remaining term equal to each award. The Company estimates forfeitures using historical results. Its estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from their estimate. There were no stock options granted during the three months ended October 1, 2010 and October 2, 2009.

The fair value of SARs, a liability award, was estimated at October 1, 2010 and October 2, 2009 using a Black-Scholes option pricing model. The Company estimated the expected term by averaging the minimum and maximum lives expected for each award. In addition, the Company estimated volatility by considering its historical stock volatility over a term comparable to the remaining expected life of each award. The risk-free interest rate is the current yield available on U.S. treasury issues with a remaining term equal to each award. The Company estimates forfeitures using historical results. Its estimates of forfeitures will be adjusted over the requisite service period based on the extent to which actual forfeitures differ, or are expected to differ, from their estimate. The assumptions for expected term, volatility and risk-free rate are presented in the table below:

|                         | October     | October     |
|-------------------------|-------------|-------------|
|                         | 1,          | 2,          |
|                         | 2010        | 2009        |
| Expected term (years)   | 0.1 - 6.0   | 0.1 - 4.8   |
| Volatility              | 139.5%      | 131.7%      |
|                         | -           | -           |
|                         | 207.8%      | 206.6%      |
| Risk-free interest rate | 0.2% - 1.6% | 0.1% - 2.1% |

Comprehensive Loss – The components of comprehensive loss are as follows (amounts in thousands):

|  | Three Months Ended | Nine Months Ended     |
|--|--------------------|-----------------------|
|  | October 1,         | October 1, October 2, |

|  | 2010        | October<br>2,<br>2009 | 2010        | 2009        |
|--|-------------|-----------------------|-------------|-------------|
| Net loss                                       | \$ (1,585 ) | \$ (810 )             | \$ (2,238 ) | \$ (3,772 ) |
| Foreign currency translation<br>(losses) gains | (7 )        | 20                    | 53          | 68          |
| Comprehensive loss                             | \$ (1,592 ) | \$ (790 )             | \$ (2,185 ) | \$ (3,704 ) |

The components of accumulated other comprehensive loss are foreign currency translation adjustments and pension and other postretirement benefits adjustments. The balance of foreign currency translation adjustments was \$0.7 million and \$0.8 million at October 1, 2010 and December 31, 2009, respectively. The balance of pension and other postretirement benefits adjustments was \$1.3 million at each of October 1, 2010 and December 31, 2009.

Segment Reporting – Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief decision maker or group in deciding how to allocate resources and in assessing performance. The Company’s chief decision maker reviews the results of operations and requests for capital expenditures based on one industry segment: manufacturing, importing and distributing commercial cleaning and storage products. The Company’s entire revenue is generated through this segment.

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## Note 2. NEW ACCOUNTING PRONOUNCEMENTS

Accounting Standards Not Yet Adopted – In October 2009, the Financial Accounting Standards Board (“FASB”) issued guidance concerning multiple-deliverable arrangements which would enable vendors to account for products or services separately rather than as a combined unit. This guidance is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is currently evaluating the impact of this guidance on its consolidated financial statements.

In January 2010, the FASB issued guidance which revises two disclosure requirements concerning fair value measurements and clarifies two others. It requires separate presentation of significant transfers into and out of Levels 1 and 2 of the fair value hierarchy and disclosure of the reasons for such transfers. It will also require the presentation of purchases, sales, issuances, and settlements within Level 3 on a gross basis rather than a net basis. The amendments also clarify that disclosures should be disaggregated by class of asset or liability and that disclosures about inputs and valuation techniques should be provided for both recurring and non-recurring fair value measurements. The guidance about Level 1 and 2 transfers was effective immediately, and the guidance about gross presentation of Level 3 activity is effective for fiscal years beginning after December 15, 2010. The adoption of this guidance had no effect on the Company’s financial position or results of operations.

## Note 3. INTANGIBLE ASSETS

Following is detailed information regarding Katy’s intangible assets (amounts in thousands):

|                | October 1,<br>2010 |                             |                           | December 31,<br>2009 |                             |                           |
|----------------|--------------------|-----------------------------|---------------------------|----------------------|-----------------------------|---------------------------|
|                | Gross<br>Amount    | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Gross<br>Amount      | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |
| Patents        | \$ 1,230           | \$ (1,028 )                 | \$ 202                    | \$ 1,202             | \$ (952 )                   | \$ 250                    |
| Customer lists | 10,231             | (8,725 )                    | 1,506                     | 10,231               | (8,582 )                    | 1,649                     |
| Tradenames     | 5,054              | (3,130 )                    | 1,924                     | 5,054                | (2,943 )                    | 2,111                     |
| Total          | \$ 16,515          | \$ (12,883 )                | \$ 3,632                  | \$ 16,487            | \$ (12,477 )                | \$ 4,010                  |

All of Katy’s intangible assets are definite long-lived intangibles. Estimated aggregate future amortization expense related to intangible assets is as follows (amounts in thousands):

|                  |         |
|------------------|---------|
| 2010 (remainder) | \$135   |
| 2011             | 517     |
| 2012             | 492     |
| 2013             | 471     |
| 2014             | 454     |
| Thereafter       | 1,563   |
|                  | \$3,632 |

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## Note 4. INDEBTEDNESS

Long-term debt consists of the following (amounts in thousands):

|  | October 1,<br>2010 | December 31,<br>2009 |
|--|--------------------|----------------------|
| Term loan payable under the PNC Credit Agreement and the Bank of America Credit Agreement, respectively, interest based on Eurodollar and Base Rates (6.51% - 8.50%)       | \$ 7,782           | \$ 6,899             |
| Revolving loans payable under the PNC Credit Agreement and the Bank of America Credit Agreement, respectively, interest based on Eurodollar and Base Rates (3.51% - 5.50%) | 14,993             | 8,856                |
| <b>Total debt</b>  | <b>22,775</b>      | <b>15,755</b>        |
| Less revolving loans, classified as current  | (14,993 )          | (8,856 )             |
| Less current maturities  | (1,138 )           | (6,899 )             |
| <b>Long-term debt</b>  | <b>\$ 6,644</b>    | <b>\$ -</b>          |

Aggregate remaining scheduled maturities of the Term Loan (as defined below) as of October 1, 2010 are as follows (amounts in thousands):

|                  |                |
|------------------|----------------|
| 2010 (remainder) | \$200          |
| 2011             | 1,275          |
| 2012             | 1,425          |
| 2013             | 4,882          |
|                  | <b>\$7,782</b> |

On May 26, 2010, Continental Commercial Products, LLC (“CCP”) and Glit/Gemtex, Ltd. (collectively, the “Borrowers”), wholly owned subsidiaries of the Company, entered into a Revolving Credit, Term Loan and Security Agreement with PNC Bank, National Association (“PNC Bank”) (the “PNC Credit Agreement”).

The PNC Credit Agreement is a \$33.2 million credit facility with an \$8.2 million term loan (the “Term Loan”) and a \$25.0 million revolving loan (the “Revolving Credit Facility”), including a \$3.5 million sub-limit for letters of credit. The proceeds of the Term Loan and Revolving Credit Facility were used to repay the Second Amended and Restated Credit Agreement with Bank of America (“Bank of America Credit Agreement”) and pay fees and expenses associated with the negotiation and consummation of the PNC Credit Agreement. All extensions of credit under the PNC Credit Agreement are collateralized by a first priority security interest in and lien upon substantially all present and future assets and properties of the Company. The Company guarantees the obligations of the Borrowers under the PNC Credit Agreement.

The principal balance of the Term Loan is payable in monthly installments followed by a final installment on May 26, 2013 equal to the then outstanding and unpaid principal balance of the Term Loan. Mandatory prepayments of the Term Loan will be required upon the occurrence of certain events, including sales of certain assets, and the Company



must make annual prepayments of the Term Loan in an amount equal to 50% of excess cash flow (as defined in the PNC Credit Agreement), provided, that for the fiscal year ending December 31, 2010, the calculation will be based on the period commencing on June 1, 2010 and ending on December 31, 2010.

The Revolving Credit Facility has an expiration date of May 26, 2013 and its borrowing base is determined by eligible inventory and accounts receivable, amounting to \$22.0 million at October 1, 2010. The Company's borrowing base under the PNC Credit Agreement is reduced by the outstanding amount of standby and commercial letters of credit. Currently, the Company's largest letters of credit relate to its casualty insurance programs. Upon extinguishment of the Bank of America Credit Agreement, the Company was required to advance cash to Bank of America as collateral for the outstanding letters of credit in the amount of \$3.1 million. At October 1, 2010, \$0.3 million was still outstanding. The cash advance is recorded within other current assets and the revolving credit agreement in the Condensed Consolidated Balance Sheets. At October 1, 2010, total outstanding letters of credit were \$2.4 million, of which \$2.1 million are issued by PNC Bank, and \$0.3 million are issued by Bank of America under the Bank of America Credit Agreement until they are transferred to PNC Bank under the PNC Credit Agreement. The PNC Credit Agreement requires the Company to have a minimum level of availability such that its eligible collateral must exceed the sum of its outstanding borrowings and letters of credit by at least \$1.5 million. This amount is reduced to zero upon the later to occur of (i) the satisfaction of certain financial covenants as set forth in the PNC Credit Agreement, supported by audited year-end financial statements of the Company on a consolidated basis for the fiscal year ending on December 31, 2010 and (ii) the reduction of the Term Loan by an aggregate sum of \$1.5 million.

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The Term Loan bears interest at the Company's option at either (i) the Eurodollar Rate (as defined in the PNC Credit Agreement), plus 6.25% or (ii) the Base Rate (as defined in the PNC Credit Agreement), plus 5.25%. Borrowings under the Revolving Credit Facility bear interest at the Company's option at either (x) the Eurodollar Rate plus 3.25% or (y) the Base Rate plus 2.25%. For U.S. dollar borrowings, the Base Rate is the highest of (i) the Federal Funds Open Rate (as defined in the PNC Credit Agreement) plus one half of 1.0%, (ii) the interest rate announced by PNC Bank as its base commercial lending rate and (iii) the sum of the Daily LIBOR Rate (as defined in the PNC Credit Agreement) plus 1.0%. For Canadian dollar borrowings, the Base Rate is the higher of (x) the interest rate announced by the PNC Bank Canada Branch as its reference rate of interest for loans in Canadian dollars to Canadian borrowers and (y) the sum of the one month CDOR Rate (as defined in the PNC Credit Agreement) plus 1.75%. An unused commitment fee of 50 basis points per annum will be payable quarterly on the average unused amount of the Revolving Credit Facility.

The PNC Credit Agreement includes financial covenants regarding minimum earnings before interest, taxes, depreciation and amortization ("EBITDA," as defined in the PNC Credit Agreement) and fixed charge coverage ratio. The Company was not in compliance with the minimum EBITDA covenant at October 1, 2010 and on November 10, 2010, obtained a waiver from PNC Bank in regards to compliance with this covenant for the third quarter of 2010. The Company was in compliance with the fixed charge coverage ratio covenant at October 1, 2010.

All of the debt under the PNC Credit Agreement is re-priced to current rates at frequent intervals. Therefore, its fair value approximates its carrying value at October 1, 2010. For the three and nine months ended October 1, 2010 and October 2, 2009, the Company had amortization of debt issuance costs, included within interest expense, of \$48,000 and \$0.4 million, and \$0.1 million and \$0.3 million, respectively. Included in amortization of debt issuance costs for the nine months ended October 1, 2010 is approximately \$0.2 million of debt issuance costs written off due to the extinguishment of the Bank of America Credit Agreement. The Company incurred \$0.6 million of debt issuance costs during the nine months ended October 1, 2010 associated with entering into the PNC Credit Agreement.

The Revolving Credit Facility under the PNC Credit Agreement requires lockbox agreements which provide for all Company receipts to be swept daily to reduce borrowings outstanding. These agreements, combined with the existence of a material adverse effect ("MAE") clause in the PNC Credit Agreement, cause the Revolving Credit Facility to be classified as a current liability, per guidance in the Accounting Standards Codification established by the Financial Accounting Standards Board. The Company does not expect to repay, or be required to repay, within one year, the balance of the Revolving Credit Facility, which is classified as a current liability. The Revolving Credit Facility does not expire or have a maturity date within one year, but rather has a final expiration date of May 26, 2013. The MAE clause, which is a fairly typical requirement in commercial credit agreements, allows the lender to require the loan to become due if it determines there has been a material adverse effect on the Company's operations, business, properties, assets, liabilities, condition, or prospects.

In addition, the Borrowers and the Company entered into an Export-Import Revolving Credit and Security Agreement with PNC Bank, which provides for up to a \$1.5 million revolving advance amount on certain foreign accounts receivable as part of the Revolving Credit Facility.

**Note 5. RETIREMENT BENEFIT PLANS**

Certain subsidiaries have pension plans covering substantially all of their employees. These plans are noncontributory, defined benefit pension plans. The benefits to be paid under these plans are generally based on employees' retirement age and years of service. The Company's funding policies, subject to the minimum funding requirements of employee benefit and tax laws, are to contribute such amounts as determined on an actuarial basis to provide the plans with assets sufficient to meet the benefit obligations. Plan assets consist primarily of fixed income

investments, corporate equities and government securities. The Company also provides certain health care and life insurance benefits for some of its retired employees. The postretirement health plans are unfunded.

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Information regarding the Company's net periodic benefit cost for pension and other postretirement benefit plans for the three and nine months ended October 1, 2010 and October 2, 2009 is as follows (amounts in thousands):

|  | Pension Benefits   |         |                   |         |
|--|--------------------|---------|-------------------|---------|
|  | Three Months Ended |         | Nine Months Ended |         |
|  | October            | October | October           | October |
|  | 1,                 | 2,      | 1,                | 2,      |
|  | 2010               | 2009    | 2010              | 2009    |
| Components of net periodic benefit cost: |                    |         |                   |         |
| Interest cost                            | \$ 18              | \$ 19   | \$ 55             | \$ 57   |
| Expected return on plan assets           | (16 )              | (14 )   | (47 )             | (40 )   |
| Amortization of net loss                 | 11                 | 12      | 33                | 34      |
| Net periodic benefit cost                | \$ 13              | \$ 17   | \$ 41             | \$ 51   |

|  | Other Benefits     |         |                   |         |
|--|--------------------|---------|-------------------|---------|
|  | Three Months Ended |         | Nine Months Ended |         |
|  | October            | October | October           | October |
|  | 1,                 | 2,      | 1,                | 2,      |
|  | 2010               | 2009    | 2010              | 2009    |
| Components of net periodic benefit cost: |                    |         |                   |         |
| Interest cost                            | \$ 12              | \$ 33   | \$ 77             | \$ 104  |
| Reversal of amortization of net loss     | (16 )              | -       | -                 | -       |
| Net periodic benefit (income) cost       | \$ (4 )            | \$ 33   | \$ 77             | \$ 104  |

During the three and nine months ended October 1, 2010, the Company made contributions to the pension plans of \$10,000 and \$31,000, respectively. The Company expects to contribute an additional \$10,000 to the pension plans throughout the remainder of 2010. The Company uses a December 31 measurement date for its pension and other postretirement benefit plans. The fair value of plan assets was determined by using quoted prices in active markets for identical assets (Level 1 inputs per the fair value hierarchy).

#### Note 6. STOCK INCENTIVE PLANS

The Company has various stock incentive plans that provide for the granting of stock options, nonqualified stock options, SARs, restricted stock, performance units or shares and other incentive awards to certain employees and directors. Options have been granted at or above the market price of the Company's stock at the date of grant, typically vest over a three-year period, and are exercisable not less than twelve months or more than ten years after the date of grant. SARs have been granted at or above the market price of the Company's stock at the date of grant, typically vest over periods up to three years, and expire ten years from the date of issue. No more than 50% of the cumulative number of vested SARs held by an employee can be exercised in any one calendar year.

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The following table summarizes stock option activity under the Company's applicable plans:

|   | Options   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(in<br>thousands) |
|---|-----------|--|---|--|
| Outstanding at December 31, 2009          | 1,501,000 | \$ 1.97                                  |   |  |
| Granted                                   | -         | \$ -                                     |   |  |
| Exercised                                 | -         | \$ -                                     |   |  |
| Expired                                   | (14,000 ) | \$ 9.93                                  |   |  |
| Cancelled                                 | -         | \$ -                                     |   |  |
| Outstanding at October 1, 2010            | 1,487,000 | \$ 1.90                                  | 6.12 years  | \$ 1   |
| Vested and Exercisable at October 1, 2010 | 987,001   | \$ 2.27                                  | 5.23 years  | \$ -   |

A summary of the status of the Company's non-vested stock options as of October 1, 2010 is presented in the table below:

|                                 | Options   | Weighted<br>Average<br>Grant<br>Date<br>Fair<br>Value |
|---------------------------------|-----------|---|
| Non-Vested at December 31, 2009 | 791,666   | \$ 0.89   |
| Granted                         | -         | \$ -  |
| Vested                          | (291,667) | \$ 0.86   |
| Cancelled                       | -         | \$ -  |
| Non-Vested at October 1, 2010   | 499,999   | \$ 0.90   |

As of October 1, 2010, total unvested compensation expense associated with stock options amounted to \$0.1 million and is being amortized on a straight-line basis over the respective options' vesting period. The weighted average period in which the above compensation cost will be recognized is 0.6 years as of October 1, 2010. The Company expects all stock options outstanding at October 1, 2010 to vest, with the exception of 83,333 options awarded under the 2008 Vice President-Sales and Marketing's Plan which were cancelled in the fourth quarter of 2010 as a result of the departure of the Company's Vice President-Sales and Marketing. Expense of \$0.1 million will be reversed in the fourth quarter of 2010 related to these unvested options. The fair value of options that vested during the nine months ended October 1, 2010 and October 2, 2009 was \$0.3 million and \$0.2 million, respectively.



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The following table summarizes SARs activity under the Company's applicable plans:

|   | SARs     | Weighted<br>Average<br>Fair<br>Value |
|---|----------|--------------------------------------|
| Non-Vested at December 31,<br>2009      | 32,000   | \$ 1.54                              |
| Granted                                 | 66,000   | \$ 0.77                              |
| Vested                                  | (6,000 ) | \$ 0.89                              |
| Cancelled                               | -        | \$ -                                 |
| Non-Vested at October 1, 2010           | 92,000   | \$ 0.80                              |
| Total Outstanding at October 1,<br>2010 | 561,267  | \$ 0.55                              |

## Note 7. INCOME TAXES

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, various states and foreign jurisdictions. The Company and its subsidiaries are generally no longer subject to U.S. federal, state and local examinations by tax authorities for years before 2005.

As of October 1, 2010 and December 31, 2009, the Company had deferred tax assets, net of deferred tax liabilities, of \$75.7 million. Domestic net operating loss ("NOL") carry forwards comprised \$48.6 million of the deferred tax assets for both periods. Katy's history of operating losses in many of its taxing jurisdictions provides significant negative evidence with respect to the Company's ability to generate future taxable income. As a result, valuation allowances have been recorded as of such dates for the full amount of deferred tax assets, net of the amount of deferred tax liabilities.

## Accounting for Uncertainty in Income Taxes

Included in the balances at October 1, 2010 and December 31, 2009 are \$0.4 million and \$0.9 million, respectively, of liabilities for unrecognized tax benefits. Because of the impact of deferred tax accounting, other than interest and penalties, the recognition of these liabilities would not affect the annual effective tax rate. The income tax benefit for the nine months ended October 1, 2010 primarily reflects current tax benefit for the recognition of uncertain tax positions of \$0.5 million due to the expiration of certain statutes of limitations. The Company anticipates reductions to the total amount of unrecognized tax benefits of an additional \$0.2 million within the next twelve months due to expiring statutes of limitations.

The Company recognizes interest and penalties accrued related to the unrecognized tax benefits in the income tax provision. The Company had approximately \$0.1 million and \$0.3 million of interest and penalties accrued at October 1, 2010 and December 31, 2009, respectively.

## Note 8. RELATED PARTY TRANSACTIONS

Kohlberg & Co., L.L.C. (“Kohlberg”), whose affiliate holds all 1,131,551 shares of the Company’s Convertible Preferred Stock, provides ongoing management oversight and advisory services to the Company. At October 1, 2010, the Company owed Kohlberg \$0.4 million for these services. This amount is recorded in accounts payable in the Condensed Consolidated Balance Sheets and selling, general and administrative expenses in the Condensed Consolidated Statements of Operations.



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Note 9. COMMITMENTS AND CONTINGENCIES

General Environmental Claims

The Company and certain of its current and former direct and indirect corporate predecessors, subsidiaries and divisions are involved in remedial activities at certain present and former locations and have been identified by the United States Environmental Protection Agency (“EPA”), state environmental agencies and private parties as potentially responsible parties (“PRPs”) at a number of hazardous waste disposal sites under the Comprehensive Environmental Response, Compensation and Liability Act (“Superfund”) or equivalent state laws and, as such, may be liable for the cost of cleanup and other remedial activities at these sites. Responsibility for cleanup and other remedial activities at a Superfund site is typically shared among PRPs based on an allocation formula. Under the federal Superfund statute, parties could be held jointly and severally liable, thus subjecting them to potential individual liability for the entire cost of cleanup at the site. Based on its estimate of allocation of liability among PRPs, the probability that other PRPs, many of whom are large, solvent, public companies, will fully pay the costs apportioned to them, currently available information concerning the scope of contamination, estimated remediation costs, estimated legal fees and other factors, the Company has recorded and accrued for environmental liabilities in amounts that it deems reasonable and believes that any liability with respect to these matters in excess of the accruals will not be material. The ultimate costs will depend on a number of factors and the amount currently accrued represents management’s best current estimate on an undiscounted basis of the total costs to be incurred. The Company expects this amount to be substantially paid over the next five to ten years.

W.J. Smith Wood Preserving Company (“W.J. Smith”)

The matter with W. J. Smith, a subsidiary of the Company, originated in the 1980s when the United States and the State of Texas, through the Texas Water Commission, initiated environmental enforcement actions against W.J. Smith alleging that certain conditions on the W.J. Smith property (the “Property”) violated environmental laws. In order to resolve the enforcement actions, W.J. Smith engaged in a series of cleanup activities on the Property and implemented a groundwater monitoring program.

In 1993, the EPA initiated a proceeding under Section 7003 of the Resource Conservation and Recovery Act (“RCRA”) against W.J. Smith and the Company. The proceeding sought certain actions at the site and at certain off-site areas, as well as development and implementation of additional cleanup activities to mitigate off-site releases. In December 1995, W.J. Smith, the Company and the EPA agreed to resolve the proceeding through an Administrative Order on Consent under Section 7003 of RCRA. While the Company has completed the cleanup activities required by the Administrative Order on Consent under Section 7003 of RCRA, the Company still has further post-closure obligations in the areas of groundwater monitoring and ongoing site operations and maintenance costs, as well as potential contractual obligations related to real estate matters.

Since 1990, the Company has spent in excess of \$7.0 million undertaking cleanup and compliance activities in connection with this matter. While ultimate liability with respect to this matter is not easy to determine, the Company has recorded and accrued amounts that it deems reasonable for prospective liabilities with respect to this matter.

Asbestos Claims

A. The Company has been named as a defendant in eleven lawsuits filed in state court in Alabama by a total of approximately 325 individual plaintiffs. There are over 100 defendants named in each case. In all eleven cases, the Plaintiffs claim that they were exposed to asbestos in the course of their employment at a former U.S. Steel plant in Alabama and, as a result, contracted mesothelioma, asbestosis, lung cancer or other illness. They claim that while in the plant they were exposed to asbestos in products which were manufactured by each defendant. In nine of the cases,

Plaintiffs also assert wrongful death claims. The Company will vigorously defend the claims against it in these matters. The liability of the Company cannot be determined at this time.

B. Sterling Fluid Systems (USA) (“Sterling”) has tendered approximately 2,800 cases pending in Michigan, New Jersey, New York, Illinois, Nevada, Mississippi, Wyoming, Louisiana, Georgia, Massachusetts, Missouri, Kentucky, California, South Carolina and Canada to the Company for defense and indemnification. With respect to one case, Sterling has demanded that the Company indemnify it for a \$200,000 settlement. Sterling bases its tender of the complaints on the provisions contained in a 1993 Purchase Agreement between the parties whereby Sterling purchased the LaBour Pump business and other assets from the Company. Sterling has not filed a lawsuit against the Company in connection with these matters.

The tendered complaints all purport to state claims against Sterling and its subsidiaries. The Company and its current subsidiaries are not named as defendants. The plaintiffs in the cases also allege that they were exposed to asbestos and products containing asbestos in the course of their employment. Each complaint names as defendants many manufacturers of products containing asbestos, apparently because plaintiffs came into contact with a variety of different products in the course of their employment. Plaintiffs claim that LaBour Pump Company, a former division of an inactive subsidiary of the Company, and/or Sterling may have manufactured some of those products.

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With respect to many of the tendered complaints, including the one settled by Sterling for \$200,000, the Company has taken the position that Sterling has waived its right to indemnity by failing to timely request it as required under the 1993 Purchase Agreement. With respect to the balance of the tendered complaints, the Company has elected not to assume the defense of Sterling in these matters.

C. LaBour Pump Company, a former division of an inactive subsidiary of the Company, has been named as a defendant in approximately 420 of the New Jersey cases tendered by Sterling. The Company has elected to defend these cases, the majority of which have been dismissed or settled for nominal sums. There are approximately 90 cases which remain active as of October 1, 2010.

While the ultimate liability of the Company related to the asbestos matters above cannot be determined at this time, the Company has recorded and accrued amounts that it deems reasonable for prospective liabilities with respect to these matters.

## Other Claims

There are a number of product liability and workers' compensation claims pending against the Company and its subsidiaries. Many of these claims are proceeding through the litigation process and the final outcome will not be known until a settlement is reached with the claimant or the case is adjudicated. The Company estimates that it can take up to ten years from the date of the injury to reach a final outcome on certain claims. With respect to the product liability and workers' compensation claims, the Company has provided for its share of expected losses beyond the applicable insurance coverage, including those incurred but not reported to the Company or its insurance providers, which are developed using actuarial techniques. Such accruals are developed using currently available claim information, and represent management's best estimates, including estimated legal fees, on an undiscounted basis. The ultimate cost of any individual claim can vary based upon, among other factors, the nature of the injury, the duration of the disability period, the length of the claim period, the jurisdiction of the claim and the nature of the final outcome.

Although management believes that the actions specified above in this section individually and in the aggregate are not likely to have outcomes that will have a material adverse effect on the Company's financial position, results of operations or cash flow, further costs could be significant and will be recorded as a charge to operations when, and if, current information dictates a change in management's estimates.

## Note 10. SEVERANCE, RESTRUCTURING AND RELATED CHARGES

In the second quarter of 2010, the Company informed employees of its intent to close the Wilen facility in Atlanta, Georgia and relocate the manufacturing and distribution functions to the CCP location in Bridgeton, Missouri. The relocation is expected to be complete by the end of 2010. A summary of charges for the three and nine months ended October 1, 2010 is as follows:

|                               | October 1, 2010          |                         |
|-------------------------------|--------------------------|-------------------------|
|                               | Three<br>Months<br>Ended | Nine<br>Months<br>Ended |
| Contract termination costs    | \$ 633                   | \$ 633                  |
| One-time termination benefits | -                        | 207                     |
| Other                         | 114                      | 162                     |
|                               | \$ 747                   | \$ 1,002                |

Total costs expected to be incurred for the relocation are \$1.2 million. Following is a rollforward of restructuring liabilities by type for the Wilen facility relocation:

|  | Total  | One-time<br>Termination<br>Benefits | Contract<br>Termination<br>Costs | Other  |
|--|--------|-------------------------------------|----------------------------------|--------|
| Restructuring liabilities at December 31, 2009 | \$-    | \$-                                 | \$-                              | \$-    |
| Additions                                      | 1,002  | 207                                 | 633                              | 162    |
| Payments                                       | (578 ) | (36 )                               | (380 )                           | (162 ) |
| Restructuring liabilities at October 1, 2010   | \$424  | \$ 171                              | \$ 253                           | \$-    |

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In 2002, the Company committed to a plan to consolidate the manufacturing and distribution of the four CCP facilities in the St. Louis, Missouri area. Management believed that in order to implement a more competitive cost structure, the excess capacity at the four plastic molding facilities in this area would need to be eliminated. This plan was completed by the end of 2003. Management believes that no further charges will be incurred for this activity, except for potential adjustments to non-cancelable lease liabilities as actual activity compares to assumptions made. Following is a rollforward of restructuring liabilities for the consolidation of St. Louis manufacturing/distribution facilities (amounts in thousands):

|   | Contract<br>Termination<br>Costs |
|---|----------------------------------|
| Restructuring liabilities at December 31,<br>2009 | \$ 415                           |
| Additions   | -                                |
| Payments  | (66 )                            |
| Other   | 96                               |
| Restructuring liabilities at October 1, 2010      | \$ 445                           |

These amounts relate to non-cancelable lease liabilities for abandoned facilities, net of potential sub-lease revenue. The amount in Other represents changes to sub-lease revenue assumptions. Total maximum potential amount of lease loss, excluding any sub-lease rentals, is \$0.9 million as of October 1, 2010. The Company has included \$0.5 million as an offset for sub-lease rentals. As of October 1, 2010, the Company does not anticipate any further significant severance, restructuring and other related charges in the upcoming year related to the plan discussed above.

The table below summarizes the future obligations for severance, restructuring and other related charges detailed above (amounts in thousands):

|                  |       |
|------------------|-------|
| 2010 (remainder) | \$497 |
| 2011             | 372   |
|                  | \$869 |



- The potential impact of changes in foreign currency exchange rates related to our Canadian operations.
- Labor issues, including union activities that require an increase in production costs or lead to a strike, thus impairing production and decreasing sales, and labor relations issues at entities involved in our supply chain, including both suppliers and those involved in transportation and shipping.
- Changes in significant laws and government regulations affecting environmental compliance and income taxes.

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## OVERVIEW

We are a manufacturer, importer and distributor of commercial cleaning and storage products. Our commercial cleaning products are sold primarily to janitorial/sanitary and foodservice distributors that supply end users such as restaurants, hotels, healthcare facilities and schools. Our storage products are primarily sold through major home improvement and mass market retail outlets.

## RESULTS OF OPERATIONS

### Three Months Ended October 1, 2010 versus Three Months Ended October 2, 2009

Net sales remained flat at \$37.6 million during the three months ended October 1, 2010 as compared to the three months ended October 2, 2009. Gross margin was 9.9% for the three months ended October 1, 2010, a decrease of 3.7 percentage points from the same period a year ago. The decrease was primarily a result of higher prices on both resin and latex binders.

Selling, general and administrative expenses were \$4.5 million for the three months ended October 1, 2010, a \$1.2 million reduction from the same period a year ago. The decrease was primarily due to prior year expenses associated with the transition and hiring of executive level personnel, a decrease in self-insurance and environmental accruals and a decrease in stock-based compensation expense.

Operating results for the three months ended October 1, 2010 were negatively impacted by severance, restructuring and related charges of \$0.7 million associated with the Company's initiative to close its Wilen facility in Atlanta, Georgia and relocate the manufacturing and distribution functions to Bridgeton, Missouri.

Interest expense increased by \$0.1 million during the three months ended October 1, 2010 as compared to the three months ended October 2, 2009 as a result of higher interest rates and average borrowings under the PNC Credit Agreement.

Overall, we reported a net loss of \$1.6 million, or \$0.20 per share, for the three months ended October 1, 2010, as compared to a net loss of \$0.8 million, or \$0.10 per share, for the three months ended October 2, 2009. The increased net loss was primarily due to the restructuring charges associated with the Company's initiative to close its Wilen facility in Atlanta, Georgia.

### Nine Months Ended October 1, 2010 versus Nine Months Ended October 2, 2009

Net sales decreased slightly from \$110.4 million during the nine months ended October 2, 2009 to \$110.1 million during the nine months ended October 1, 2010. Gross margin was 12.1% for the nine months ended October 1, 2010, a decrease of 2.8 percentage points from the same period a year ago. Gross margin was impacted by an unfavorable variance in our LIFO adjustment of \$1.5 million resulting from an increase in resin prices. Excluding the LIFO adjustment, gross margin for the nine months ended October 1, 2010 decreased 1.5 percentage points from the nine months ended October 2, 2009. The decrease was primarily a result of higher prices on both resin and latex binders.

Selling, general and administrative expenses were \$16.4 million for the nine months ended October 1, 2010, a \$3.4 million reduction from the same period a year ago. The decrease was primarily due to prior year expenses associated with the transition and hiring of executive level personnel, a decrease in self-insurance accruals and a decrease in stock-based compensation expense.



Operating results for the nine months ended October 1, 2010 were negatively impacted by severance, restructuring and related charges of \$1.0 million associated with the Company's initiative to close its Wilen facility in Atlanta, Georgia and relocate the manufacturing and distribution functions to Bridgeton, Missouri.

Interest expense increased by \$0.4 million during the nine months ended October 1, 2010 as compared to the nine months ended October 2, 2009 primarily as a result of \$0.2 million of debt issuance costs being written off with the extinguishment of the Bank of America Credit Agreement, as well as higher interest rates and average borrowings under the PNC Credit Agreement.

Other income during the nine months ended October 1, 2010 consists of a \$2.1 million gain recognized from a settlement of an existing obligation due to Pentland USA, Inc. ("Pentland"), \$0.3 million in proceeds from the sale of process technology and \$0.1 million in interest income.

The income tax benefit for the nine months ended October 1, 2010 includes a benefit for the recognition of uncertain tax positions of \$0.5 million as the statutes of limitations on certain tax years expired.

Overall, we reported a net loss of \$2.2 million, or \$0.28 per share, for the nine months ended October 1, 2010, as compared to a net loss of \$3.8 million, or \$0.47 per share, for the nine months ended October 2, 2009.

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## LIQUIDITY AND CAPITAL RESOURCES

We require funding for working capital needs and capital expenditures. We believe that our cash flow from operations and the use of available borrowings under the PNC Credit Agreement (as defined below) provide sufficient liquidity for our operations going forward. As of October 1, 2010, we had cash of \$0.6 million as compared to cash of \$0.7 million at December 31, 2009. As of October 1, 2010, we had outstanding borrowings of \$22.8 million (67% of total capitalization) under the PNC Credit Agreement (as defined below). Our unused borrowing availability at October 1, 2010 on the Revolving Credit Facility (as defined below) was \$3.4 million after the \$1.5 million minimum availability requirement discussed below. As of December 31, 2009, we had outstanding borrowings of \$15.8 million (54% of total capitalization) with unused borrowing availability of \$1.3 million after the \$5.0 million minimum availability requirement under the Bank of America Credit Agreement (as defined below).

### PNC Credit Agreement

On May 26, 2010, Continental Commercial Products, LLC and Glit/Gemtex, Ltd. (collectively, the “Borrowers”), wholly owned subsidiaries of the Company, entered into a Revolving Credit, Term Loan and Security Agreement with PNC Bank, National Association (“PNC Bank”) (the “PNC Credit Agreement”).

The PNC Credit Agreement is a \$33.2 million credit facility with an \$8.2 million term loan (the “Term Loan”) and a \$25.0 million revolving loan (the “Revolving Credit Facility”), including a \$3.5 million sub-limit for letters of credit. The proceeds of the Term Loan and Revolving Credit Facility were used to repay the Second Amended and Restated Credit Agreement with Bank of America (“Bank of America Credit Agreement”) and pay fees and expenses associated with the negotiation and consummation of the PNC Credit Agreement. The PNC Credit Agreement results in two important benefits related to our long-term strategy: (1) the reduction of the availability block under the Revolving Credit Facility from \$5.0 million to \$1.5 million allows for additional borrowing capacity and increased working capital flexibility and (2) the additional \$1.7 million availability under the Term Loan allowed us to negotiate a settlement of an existing obligation due to Pentland, whereby we accelerated all amounts due to Pentland in 2010 of \$1.9 million and paid an additional \$0.1 million in satisfaction of a liability of \$4.1 million. This settlement eliminates cash requirements of \$1.8 million in 2011 and \$0.4 million in 2012.

All extensions of credit under the PNC Credit Agreement are collateralized by a first priority security interest in and lien upon substantially all present and future assets and properties of the Company. The Company guarantees the obligations of the Borrowers under the PNC Credit Agreement.

The principal balance of the Term Loan is payable in monthly installments followed by a final installment on May 26, 2013 equal to the then outstanding and unpaid principal balance of the Term Loan. Mandatory prepayments of the Term Loan will be required upon the occurrence of certain events, including sales of certain assets, and the Company must make annual prepayments of the Term Loan in an amount equal to 50% of excess cash flow (as defined in the PNC Credit Agreement), provided, that for the fiscal year ending December 31, 2010, the calculation will be based on the period commencing on June 1, 2010 and ending on December 31, 2010.

The Revolving Credit Facility has an expiration date of May 26, 2013 and its borrowing base is determined by eligible inventory and accounts receivable, amounting to \$22.0 million at October 1, 2010. The Company’s borrowing base under the PNC Credit Agreement is reduced by the outstanding amount of standby and commercial letters of credit. Currently, the Company’s largest letters of credit relate to its casualty insurance programs. Upon extinguishment of the Bank of America Credit Agreement, the Company was required to advance cash to Bank of America as collateral for the outstanding letters of credit in the amount of \$3.1 million. At October 1, 2010, \$0.3 million was still outstanding. The cash advance is recorded within other current assets and the revolving credit agreement in the Condensed Consolidated Balance Sheets. At October 1, 2010, total outstanding letters of credit were

\$2.4 million, of which \$2.1 million are issued by PNC Bank, and \$0.3 million are issued by Bank of America under the Bank of America Credit Agreement until they are transferred to PNC Bank under the PNC Credit Agreement. The PNC Credit Agreement requires the Company to have a minimum level of availability such that its eligible collateral must exceed the sum of its outstanding borrowings and letters of credit by at least \$1.5 million. This amount is reduced to zero upon the later to occur of (i) the satisfaction of certain financial covenants as set forth in the PNC Credit Agreement, supported by audited year-end financial statements of the Company on a consolidated basis for the fiscal year ending on December 31, 2010 and (ii) the reduction of the Term Loan by an aggregate sum of \$1.5 million.

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The Term Loan bears interest at the Company's option at either (i) the Eurodollar Rate (as defined in the PNC Credit Agreement), plus 6.25% or (ii) the Base Rate (as defined in the PNC Credit Agreement), plus 5.25%. Borrowings under the Revolving Credit Facility bear interest at the Company's option at either (x) the Eurodollar Rate plus 3.25% or (y) the Base Rate plus 2.25%. For U.S. dollar borrowings, the Base Rate is the highest of (i) the Federal Funds Open Rate (as defined in the PNC Credit Agreement) plus one half of 1.0%, (ii) the interest rate announced by PNC Bank as its base commercial lending rate and (iii) the sum of the Daily LIBOR Rate (as defined in the PNC Credit Agreement) plus 1.0%. For Canadian dollar borrowings, the Base Rate is the higher of (x) the interest rate announced by the PNC Bank Canada Branch as its reference rate of interest for loans in Canadian dollars to Canadian borrowers and (y) the sum of the one month CDOR Rate (as defined in the PNC Credit Agreement) plus 1.75%. An unused commitment fee of 50 basis points per annum will be payable quarterly on the average unused amount of the Revolving Credit Facility.

The PNC Credit Agreement includes financial covenants regarding minimum earnings before interest, taxes, depreciation and amortization ("EBITDA," as defined in the PNC Credit Agreement) and fixed charge coverage ratio. The Company was not in compliance with the minimum EBITDA covenant at October 1, 2010 and on November 10, 2010, obtained a waiver from PNC Bank in regards to compliance with this covenant for the third quarter of 2010. The Company was in compliance with the fixed charge coverage ratio covenant at October 1, 2010.

All of the debt under the PNC Credit Agreement is re-priced to current rates at frequent intervals. Therefore, its fair value approximates its carrying value at October 1, 2010. For the three and nine months ended October 1, 2010 and October 2, 2009, the Company had amortization of debt issuance costs, included within interest expense, of \$48,000 and \$0.4 million, and \$0.1 million and \$0.3 million, respectively. Included in amortization of debt issuance costs for the nine months ended October 1, 2010 is approximately \$0.2 million of debt issuance costs written off due to the extinguishment of the Bank of America Credit Agreement. The Company incurred \$0.6 million of debt issuance costs during the nine months ended October 1, 2010 associated with entering into the PNC Credit Agreement.

The Revolving Credit Facility under the PNC Credit Agreement requires lockbox agreements which provide for all Company receipts to be swept daily to reduce borrowings outstanding. These agreements, combined with the existence of a material adverse effect ("MAE") clause in the PNC Credit Agreement, cause the Revolving Credit Facility to be classified as a current liability, per guidance in the Accounting Standards Codification established by the Financial Accounting Standards Board. The Company does not expect to repay, or be required to repay, within one year, the balance of the Revolving Credit Facility, which is classified as a current liability. The Revolving Credit Facility does not expire or have a maturity date within one year, but rather has a final expiration date of May 26, 2013. The MAE clause, which is a fairly typical requirement in commercial credit agreements, allows the lender to require the loan to become due if it determines there has been a material adverse effect on the Company's operations, business, properties, assets, liabilities, condition, or prospects.

In addition, the Borrowers and the Company entered into an Export-Import Revolving Credit and Security Agreement with PNC Bank, which provides for up to a \$1.5 million revolving advance amount on certain foreign accounts receivable as part of the Revolving Credit Facility.

### Cash Flows

Cash provided by operating activities before changes in operating assets and liabilities was \$0.8 million in the nine months ended October 1, 2010 as compared to \$2.0 million in the same period of 2009. This variance was primarily a result of a \$1.5 million reduction in net loss from operations year over year, offset by a \$2.1 million gain recognized from a settlement of an existing obligation due to Pentland. Changes in operating assets and liabilities used \$5.8 million in the nine months ended October 1, 2010 as compared to providing \$1.5 million in the same period of 2009. The current year usage was primarily a result of an increase in accounts receivable and a decrease in other

liabilities, partially offset by an increase in accounts payable. The change in accounts receivable was due to increased sales from the fourth quarter of 2009 to the third quarter of 2010. The decrease in other liabilities was a result of the settlement of an existing obligation due to Pentland. The increase in accounts payable was primarily a result of improved payment terms with certain vendors and the timing of resin purchases. As of October 1, 2010 we were turning our inventory at 4.5 times per year as compared to 3.9 times per year as of December 31, 2009 and 4.7 times per year as of October 2, 2009.

Cash flows provided by financing activities in the nine months ended October 1, 2010 reflect a \$7.0 million increase in our debt levels since December 31, 2009, partially offset by \$0.6 million in direct costs associated with refinancing. As previously discussed, debt levels increased during the nine months ended October 1, 2010 as a result of the refinancing with PNC Bank, the payments to Pentland in the amount of \$2.0 million, and a \$3.0 million increase in accounts receivable.

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OFF-BALANCE SHEET ARRANGEMENTS

As of October 1, 2010, the Company had no off-balance sheet arrangements.

SEVERANCE, RESTRUCTURING AND RELATED CHARGES

See Note 10 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion of severance, restructuring and related charges.

ENVIRONMENTAL AND OTHER CONTINGENCIES

See Note 9 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of environmental and other contingencies.

R E C E N T L Y I S S U E D A C C O U N T I N G  
P R O N O U N C E M E N T S

See Note 2 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of recently issued accounting pronouncements.

CRITICAL ACCOUNTING POLICIES

We disclosed details regarding certain of our critical accounting policies in the Management's Discussion and Analysis section of our Annual Report on Form 10-K for the year ended December 31, 2009 (Part II, Item 7). There have been no changes to these policies as of October 1, 2010.

Item 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our filings with the Securities and Exchange Commission ("SEC") is reported within the time periods specified in the SEC's rules, regulations and related forms, and that such information is accumulated and communicated to our management, including the principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Katy carried out an evaluation, under the supervision and with the participation of our management, including the principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (pursuant to Rule 13a-15(e) under the Exchange Act) as of the end of the period of our report. Based upon that evaluation, the principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

There have been no changes in Katy's internal control over financial reporting during the quarter ended October 1, 2010 that have materially affected, or are reasonably likely to materially affect, Katy's internal control over financial reporting.



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## PART II - OTHER INFORMATION

### Item 1. LEGAL PROCEEDINGS

Except as otherwise noted in Note 9 to the Condensed Consolidated Financial Statements in Part I, Item 1 of this Quarterly Report on Form 10-Q, during the quarter for which this report is filed, there have been no material developments in previously reported legal proceedings, and no other cases or legal proceedings, other than ordinary routine litigation incidental to the Company's business and other nonmaterial proceedings, were brought against the Company.

### Item 1A. RISK FACTORS

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results are described in Part I, Item 1A of our Annual Report on Form 10-K, filed on March 25, 2010. There has been no material change in those risk factors.

### Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

### Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

### Item 4. (REMOVED AND RESERVED)

### Item 5. OTHER INFORMATION

None.

### Item 6. EXHIBITS

Exhibit  
Number

Exhibit Title

|             |  |
|-------------|--|
| <u>31.1</u> | <u>CEO Certification pursuant to Securities Exchange Act Rule 13a-14, as adopted* pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>31.2</u> | <u>CFO Certification pursuant to Securities Exchange Act Rule 13a-14, as adopted* pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| <u>32.1</u> | <u>CEO Certification required by 18 U.S.C. Section 1350, as adopted pursuant to*# Section 906 of the Sarbanes-Oxley Act of 2002.</u>             |
| <u>32.2</u> | <u>CFO Certification required by 18 U.S.C. Section 1350, as adopted pursuant to*# Section 906 of the Sarbanes-Oxley Act of 2002.</u>             |

\* Indicates filed herewith.

# These certifications are being furnished solely to accompany this report pursuant to 18 U.S.C. Section 1350, and are not being filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and are not to be



incorporated by reference into any filing of Katy Industries, Inc. whether made before or after the date hereof, regardless of any general incorporation language in such filing.

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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.

KATY INDUSTRIES, INC.  
Registrant

DATE: November 15, 2010

By /s/ David J. Feldman

David J. Feldman

President and Chief Executive Officer

By /s/ James W. Shaffer

James W. Shaffer

Vice President, Treasurer and Chief Financial Officer