

Lumber Liquidators, Inc.  
Form 424B4  
November 13, 2007  
**Table of Contents**

**Filed Pursuant to Rule 424(b)(4)**

**File No. 333-142309**



**Table of Contents**

**Table of Contents**

**Table of Contents**

**Table of Contents**

TABLE OF CONTENTS

	Page
<u>Prospectus Summary</u>	1
<u>Risk Factors</u>	11
<u>Forward-Looking Statements</u>	21
<u>Use Of Proceeds</u>	22
<u>Dividend Policy</u>	22
<u>Capitalization</u>	23
<u>Dilution</u>	24
<u>Unaudited Pro Forma Financial Information</u>	26
<u>Selected Financial Data</u>	32
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	34
<u>Business</u>	55
<u>Management</u>	76
<u>Certain Relationships and Related Party Transactions</u>	97
<u>Principal and Selling Stockholders</u>	101
<u>Description of Capital Stock</u>	103
<u>Shares Eligible for Future Sale</u>	106
<u>Underwriting</u>	108
<u>Validity of the Common Stock</u>	112
<u>Experts</u>	112
<u>Where You Can Find Additional Information</u>	112
<u>Index to Financial Statements</u>	F-1

**Table of Contents**

**PROSPECTUS SUMMARY**

*The following summary highlights information appearing elsewhere in this prospectus. This summary does not contain all of the information you should consider before investing in our common stock. You should read this entire prospectus carefully. In particular, you should read the sections entitled Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and the notes relating to those statements.*

**The Company**

Lumber Liquidators is the largest specialty retailer of hardwood flooring in the United States, based on industry sources and our experience. We believe we have achieved a reputation for offering great value, superior service and a broad selection of high-quality hardwood flooring products. We offer an extensive selection of premium hardwood flooring products under multiple proprietary brands at everyday low prices designed to appeal to a diverse customer base. We believe that our vertically integrated business model enables us to offer a broad assortment of high-quality products to our customers at a lower cost than our competitors. As of September 30, 2007, we sold our products through 111 Lumber Liquidators stores in 42 states, a call center, our website and a catalog. We believe that our brands, value proposition and integrated multi-channel approach are important competitive advantages.

We offer hardwood flooring products from more than 25 domestic and exotic wood species in both prefinished and unfinished brands of various widths and lengths. Our products are differentiated in terms of quality and price based on the species, grade of the hardwood, quality of finishing, as well as the length of the warranty. We also offer a broad assortment of flooring enhancements and installation accessories including moldings, noise-reducing underlays and adhesives. Our product offering is substantially comprised of our proprietary brands, including our premium Bellawood brand as well as our Builder's Pride, Virginia Mill Works, Schön, Morning Star Bamboo and Dream Home brands. We have experienced strong historical growth, including net sales growth from \$171.8 million in 2004 to \$332.1 million in 2006, operating income growth from \$7.2 million in 2004 to \$21.4 million in 2006 and net income growth from \$8.0 million in 2004 to \$12.9 million in 2006, representing compound annual growth rates of approximately 39%, 73% and 27%, respectively. In the first nine months of 2007, our net sales were \$299.8 million, which represents a 21% increase over the first nine months of 2006. Our operating income for the first nine months of 2007 declined to \$13.9 million from \$18.7 million in the first nine months of 2006, and our net income declined to \$8.3 million from \$11.3 million for the same periods. Our overall growth has been driven in large part by the opening of 86 stores since January 1, 2003 and our strong comparable store sales performance in each of those periods. On an annual basis, comparable store sales increased 19.0% from 2004 to 2005, and 17.3% from 2005 to 2006. In the first nine months of 2007, comparable store sales increased 8.6% over the first nine months of 2006, which increased 19.2% over the first nine months of 2005.

Our company started in 1994 when Tom Sullivan, the chairman of our board of directors, began selling discounted building materials. In 1996, he identified an opportunity to sell hardwood flooring at liquidator prices. Tom observed that traditional home improvement and flooring retailers underserved customers in terms of price, selection, product quality and overall value. Tom began working directly with vendors and mills to provide customers with broad, high-quality assortments at everyday low prices including premium categories. Since our first retail store opened in 1996, we have developed a national store base. Approximately 80% of our sales are to existing homeowners engaged in remodeling projects, and the remainder are to small independent contractors engaged in remodeling and new home-building projects. In 2004, we moved to our Toano, Virginia distribution center and finishing facility, where we currently finish approximately 70% of our premium Bellawood products. We maintain our in-house finishing capability to ensure product quality and to reduce third-party finishing costs.

## Table of Contents

We have made a significant investment in developing our national brands, including our portfolio of proprietary product offerings. We believe Lumber Liquidators is now recognized across the United States as a destination for high-quality hardwood flooring at everyday low prices, while our Bellawood brand is known as a premium flooring brand within the industry. Our stores typically consist of a warehouse and an attached showroom located in industrial or commercial areas that have lower rents than traditional retail locations, are accessible from major roadways and have significant visibility to passing traffic. Our average store is approximately 6,400 square feet, of which approximately 800 square feet is devoted to the showroom selling area. We have designed our stores using a visually appealing and distinctive showroom format to enhance the customer experience while demonstrating our low-cost approach to doing business. We employ knowledgeable sales staff who can educate our customers about the product. We believe that our stores reinforce our customers' belief that they get a good deal when they buy from us.

From 1994 until 2004, Tom Sullivan was our sole shareholder and director. In December 2004, we issued approximately 7.9 million shares of convertible preferred stock to funds managed by TA Associates, Inc., a private equity investment firm, in return for \$35.0 million. Immediately prior to the issuance of those shares, which are convertible into shares of common stock on a one-to-one basis, we implemented a 150,000 to 1 stock split to increase the number of common shares held by Tom from 100 to approximately 15.0 million. After completion of the initial public offering, Tom and TA Associates, each of whom is a selling stockholder, will control approximately 37% and 22% of our outstanding common stock, respectively (or approximately 20% and 33%, respectively, if the underwriters' overallotment option is exercised in full), which also reflects the transfer of an estimated 926,000 shares from Tom to Kevin Sullivan, who is Tom's brother and one of our regional managers, pursuant to an existing stock-based compensation agreement between them (which we refer to in this prospectus as the "Variable Plan"). During the periods in which Tom was the sole shareholder, we made cash distributions to him from time to time, including amounts to enable him to pay taxes on deemed income during the period when we were an S corporation (from inception until December 2004). We distributed \$42.6 million in cash to Tom in 2004, including \$30.0 million of the proceeds from the sale of the convertible preferred stock (which represented a significant dilution of his ownership interest), \$5.0 million to enable him to pay taxes on deemed income and \$7.6 million of additional cash. As a result of these transactions, we had a total stockholders' deficit of \$30.2 million as of December 31, 2004, which has steadily improved to stockholders' equity of \$4.1 million as of September 30, 2007. We have not made any other cash or equity distributions to our directors, executive officers or other employees in the past three years (other than paying salaries and making equity-based compensation grants in the ordinary course), and no directors, officers or employees other than Tom will receive any proceeds from this offering.

## **Competitive Strengths**

We believe the following competitive strengths contribute to our leading market position, differentiate us from our competition and will drive our future growth:

***Attractive Store Economics.*** We operate a store model that produces strong returns on investment by combining low capital investment, a small store footprint, minimal staffing and a high average sale of more than \$1,750 in 2006. Our average new store across our markets has historically become profitable within three months of beginning operations and returned its initial cash investment within seven months. Our store model targets a pre-tax return on invested capital in excess of 140% for stores open more than three years (including all advertising costs). For the twelve months ended September 30, 2007, we did not have an unprofitable store on a four-wall basis in our portfolio (excluding stores open for less than three months). When measuring profitability on a four-wall basis, we take into account the sales and costs of sales at each individual store, as well as the expenses of that store, which include wages and benefits, rent and



**Table of Contents**

local advertising. We do not consider national advertising and store support costs, including those related to corporate overhead and our distribution facility, when calculating profitability on a four-wall basis.

***Appealing Value Proposition.*** Our value proposition to the customer is a key driver of our business. Important components include:

***Price.*** A fundamental part of our founding philosophy is to provide quality hardwood flooring brands at everyday low prices. We are able to maintain these prices across our product range because we purchase flooring directly from mills and brokers. In addition, we operate a low-cost store model with a no frills showroom, limited in-store inventory and locations in industrial or commercial areas that carry lower rent expense than many retail stores.

***Selection.*** We have developed a broad product assortment of domestic and exotic hardwoods sold under proprietary brands that help us to differentiate our products from those of our competitors. We offer products across a range of price points and quality levels that allow us both to target discrete market segments and to appeal to diverse groups of customers.

***Quality.*** We believe that we have achieved a reputation for quality, and that our proprietary brands are recognized for excellence by our customers. We work directly with our supplier mills and brokers to produce flooring that will meet our high quality standards and we also currently finish approximately 70% of our premium Bellawood products at our state-of-the-art Toano facility. We maintain an in-house inspection and quality control function and enforce strict certification requirements for Bellawood supplier mills. As a result, we offer a 50-year residential warranty on our premier Bellawood brands, which we believe is the industry's longest.

***Availability.*** Since our founding, we have made it a priority to build long-term relationships with our key supplier mills and brokers. As we have grown, we believe our relationships with our suppliers have strengthened, which we believe helps us ensure our continued access to a broad selection of domestic and exotic hardwood products at attractive prices. We believe that these direct supplier relationships are relatively unique in our industry, and offer us a significant competitive advantage. In addition, we believe our supply chain and centralized inventory at our Toano distribution facility allow us to meet the delivery needs of our customers better than our competitors.

***Established National Brands.*** We believe both Lumber Liquidators and Bellawood are well-known national brands. We have positioned Lumber Liquidators to represent an attractive value proposition to the customer, and believe we offer superior service and hardwood flooring expertise. Based on our market research, we believe that Bellawood, which accounted for approximately one-third of our 2006 net sales, is among the most-recognized brands in our industry. We are committed to supporting our brands and products through diverse national marketing campaigns that reach a wide variety of potential customers. We believe that we benefit from our long-term endorsement relationships with respected and well-known home improvement celebrities such as Bob Vila and Ty Pennington.

***Integrated Multi-Channel Sales Model.*** We have an integrated multi-channel sales model that enables our national store network, call center, website and catalog to work together in a coordinated manner. Our sales strategy emphasizes customer service by providing superior convenience and education tools for our customers to learn about our products and the installation process. We strive to use our various sales channels to make our customers' transactions easy and efficient.

**Table of Contents**

***Experienced Management Team with a Proven Track Record.*** Our senior management team has extensive experience with publicly traded, high-growth retail companies. We believe our company benefits in particular from the leadership of Tom Sullivan, our founder and the chairman of our board of directors, who is a veteran of the specialty hardwood flooring retail business. Jeff Griffiths, our president and chief executive officer, has more than 30 years of experience in the retail industry and our chief financial officer, Dan Terrell, has more than 15 years of experience working with reporting companies in the retail industry. Over the past two years, we have assembled a management team with extensive experience in the specialty retail and hardline retail industries. Upon completion of this offering, our executive officers and directors will beneficially own approximately 38% of our company (excluding shares owned by TA Associates funds).

**Growth Strategy**

We intend to continue to increase revenues and profitability by strengthening our position as a leading provider of hardwood flooring within our growing market. Specific elements of our strategy for continued growth include the following:

***Expand Our Store Base.*** The hardwood flooring market is highly fragmented, and we believe there is a significant opportunity to expand our store base. Because of the low capital investment to open new stores and the attractive returns on investment that our stores generate, we intend to continue to expand our store base. We plan to open at least 25 new stores in total during 2007 and between 30 and 40 new stores during each of the next several years thereafter.

***Improve Existing Store Sales Growth.*** We seek to drive productivity through strong comparable store sales performance and by improving operational efficiencies. We expect sales growth will be driven by our investment in our proprietary brands, targeted marketing campaigns and more efficient sales and inventory planning and forecasting, as well as favorable long-term industry trends. In addition, we continue to build on what we believe is our strong track record of consistent store-level execution.

***Expand Operating Margins.*** We attribute our success to our focus on and our ability to deliver on our value proposition to the customer, which results from leveraging our strength as a vertically-integrated, low-cost operator. As we continue to increase our revenues by opening new stores and marketing our proprietary brands, we also plan to decrease marginal costs by taking advantage of improving economies of scale in purchasing, leveraging our existing infrastructure and other fixed expenses and optimizing our finishing, distribution and supply chain management.

***Leverage Brand Marketing Across Multiple Channels.*** We use our advertising and marketing activities and our multiple sales channels to help educate potential customers about hardwood flooring. As customers learn more about hardwood flooring and how best to shop for it, they also learn more about our products and value proposition, which we believe drives customer store visits and purchases of our products. We believe that as we continue to leverage our multi-channel strategy, we will drive repeat customer traffic. We have also made a significant advertising and marketing investment to link our brands to quality and value as well as to establish ourselves as the hardwood flooring experts. As we continue to grow and open more stores, we believe that our marketing and branding activities will become more efficient and targeted. We also believe that our customer acquisition costs will decline on both a per-customer and per-store basis.

## Table of Contents

### **Our Market**

The hardwood flooring market represents approximately 10% of the overall U.S. floor coverings market. Catalina Research Inc. estimates that the value of U.S. hardwood flooring wholesale sales in 2005 was approximately \$2.3 billion (representing retail sales of \$4.1 billion), and, in addition, estimated in November 2005 that the market would grow at a compound annual growth rate of 7.4% through 2011. Although we anticipate there may be some volatility in the near term due to decreased housing demand, which that growth estimate may not fully reflect, we believe we will continue to benefit from several key long-term industry trends and characteristics including increased home improvement spending (which is driven by several factors including the aging of existing housing stock, increasing home ownership levels, the increasing average size of homes and favorable demographic trends), especially by persons engaged in home remodeling projects. Other trends that we expect to benefit from include the evolution of the hardwood flooring market to include both a wider range of wood species and products that are increasingly easier and less costly to install, and the greater attractiveness of hardwood flooring as industry innovations drive growth and its perceived cosmetic, durability and health advantages.

### **Risk Factors**

We face a number of risks in operating our business, including risks that may prevent us from achieving our business objectives or that may affect our business, financial condition and operating results. You should consider these risks before investing in our company. For example:

***Dependence on the Economy, Home Remodeling Activity and the Homebuilding Industry.*** Our industry is highly dependent on the remodeling of existing homes and new home construction, which depend on factors such as interest rates, tax policy, employment levels, consumer confidence, credit availability, real estate prices, demographic trends, weather conditions, natural disasters and general economic conditions. Market trends or other events that limit discretionary consumer spending, reduce spending on remodeling of existing homes and cause purchases of new homes to decline could adversely affect our operations. For example, Catalina Research estimates that U.S. hardwood flooring square-foot sales declined 10.6% in 2006 and declined 14.1% in the first half of 2007 compared to the same period in 2006, principally as a result of decreased new housing demand.

***Unpredictability of Future Results.*** Our growth strategy, and the investment associated with the development of new stores, may cause our operating results to fluctuate and be unpredictable or decrease our profits. Our future results will depend on factors that include successfully selecting new markets and store locations, negotiating leases on acceptable terms, managing construction, occupancy and operating costs, maintaining the quality of our operations, developing consumer recognition of the quality of our products, meeting customer demand and the continued popularity of hardwood flooring. In addition, as we open more stores, our rate of expansion relative to the size of our store base will decline, newly opened stores may not succeed or may reach profitability more slowly than we expect, and the ramp-up to profitability may become longer in the future.

***Managing our Growth Effectively.*** Our existing management information systems, including our store management systems and financial and management controls, may be unable to support our planned expansion. We will need to continue to enhance these systems, procedures and controls, to hire, train and retain regional managers, store managers and store staff and to integrate newly hired management personnel.

***Continued Availability of Sufficient Suitable Hardwood.*** Some of the hardwood species we sell are scarce, and we cannot be assured of their continued availability. Our ability to obtain an adequate volume and quality of hard-to-find species depends on our suppliers' ability to furnish

## Table of Contents

those species, which, in turn, could be affected by events such as forest fires, insect infestation, tree diseases, prolonged drought, other adverse weather conditions, changes in government regulations relating to forest management practices and changes to regulations and forest management policies.

***Reliance on and Relationships with Certain Suppliers.*** Our 10 largest suppliers accounted for approximately 63% of our purchases in 2006, including one supplier that represented approximately 14% of our purchases and acted as agent for a second supplier that accounted for another 7%. We generally do not have long-term contracts with our suppliers, and they may be unable to supply us in the future due to various factors. In addition, in order to retain the competitive advantage that we believe results from our direct supplier relationships, we need to continue to identify, develop and maintain relationships with qualified mills that can satisfy our high standards for quality and our requirements for hardwood in a timely and efficient manner.

***Increased Hardwood or Delivery Costs.*** The costs of the species of hardwood that we use in our products and delivery costs (particularly fuel costs) can fluctuate due to various factors, and we may not always be able to increase the selling prices of our products in response to increases in those costs.

We also face a number of other risks relating to various aspects of our business and operations, including the possibility of disruptions to our management information systems, call center or website; our ability to hire and retain qualified officers, managers and employees; increasing competitive pressures; problems potentially arising at our single finishing and distribution center; the continued effectiveness of our advertising and product endorsement strategy; and concentrated shareholder ownership. You should carefully consider the risks discussed in **Risk Factors** before deciding to invest in our common stock.

## **Our Corporate History and Principal Office**

We were incorporated in Massachusetts in 1994 as Lumber Liquidators, Inc., and became a Delaware corporation in August 2007 in connection with this offering. Our corporate and principal executive office is located at 3000 John Deere Road, Toano, Virginia 23168. Our telephone number is (757) 259-4280, and we maintain a website at [www.lumberliquidators.com](http://www.lumberliquidators.com) on which we will post all reports we file with the Securities and Exchange Commission, or the SEC, under Section 13(a) of the Securities Exchange Act of 1934 after the closing of this offering. We also will post on this site our key corporate governance documents, including our board committee charters, our ethics policy and our principles of corporate governance. We also offer information about our premium Bellawood brand on a separate website at [www.bellawood.com](http://www.bellawood.com) and about the Ty Pennington collection at [www.tyscollection.com](http://www.tyscollection.com). Information on these websites is not, however, a part of this prospectus.

Although we may be a controlled company under the rules of the New York Stock Exchange (because our directors and officers may collectively beneficially own a majority of our common stock following this offering, depending on whether and to what extent the underwriters exercise their option to purchase additional shares and whether and to what extent those directors and officers exercise outstanding stock options they hold), we will not make use of the exemptions available to controlled companies under those rules, which permit a controlled company to have a board with fewer than a majority or no independent directors and to avoid having either a compensation committee or a nominating and corporate governance committee (or for such committees to include or consist of non-independent directors). After this offering closes, a majority of our directors will be independent, and our compensation and nominating and corporate governance committees will be comprised solely of independent directors.

**Table of Contents**

**Sources of Market and Industry Data**

This prospectus includes market share and industry data and forecasts that we have obtained from internal company surveys, market research, consultant surveys, publicly available information and industry publications and surveys. Information regarding the hardwood flooring market is derived from Catalina Research Inc.'s *November 2005 Wood Flooring Report* and *March 2007, June 2007* and *September 2007 Floor Coverings Industry Quarterly Updates* and other sources identified herein. Information regarding our market position has been derived in part from information in *Floor Covering Weekly* and *Floor Focus* magazines. Except where otherwise noted, statements as to our position relative to our competitors or as to market share refer to the most recent available data.

**Use of Trademarks and Trade Names**

We have a number of registered marks, including Lumber Liquidators®, Bellawood®, 1-800-FLOORING®, the Lumber Liquidators design mark and others, in several jurisdictions including the United States, and we have also applied to register a number of other marks in various jurisdictions. See Business Intellectual Property and Trademarks. This prospectus also contains trademarks and trade names of other companies. All trademarks and trade names appearing in this prospectus are the property of their respective holders.

**Table of Contents**

**The Offering**

Common stock offered by us	3,800,000 Shares
Common stock offered by the selling stockholders	6,200,000 Shares
Common stock to be outstanding after this offering	26,752,118 Shares
Use of proceeds	We estimate that the net proceeds to us from this offering will be approximately \$36.4 million.  We will not receive any proceeds from the sale of shares by the selling stockholders. The selling stockholders include the chairman of our board of directors. See <u>Use of Proceeds</u> for more information.  We intend to repay all amounts outstanding under the term-loan portion of our senior secured loan agreement and our new revolving credit agreement (approximately \$14.1 million in aggregate as of September 30, 2007) using proceeds from this offering. We intend to use the remainder of the net proceeds of this offering to provide additional long-term capital to support the growth of our business and for general corporate purposes.
Dividends	We do not anticipate paying any cash dividends in the foreseeable future.
New York Stock Exchange symbol	LL
Risk Factors	See <u>Risk Factors</u> beginning on page 11 and other information included in this prospectus for a discussion of factors that you should carefully consider before investing in our common stock.

The number of shares of common stock that will be outstanding after this offering in the table above excludes 1,846,847 shares of common stock issuable upon exercise of outstanding stock options with a weighted average exercise price of \$7.76 per share, of which 261,260 shares had vested as of September 30, 2007.

Except as otherwise noted, all information in this prospectus:

assumes that the underwriters do not exercise their option to purchase up to 1,500,000 additional shares of common stock from the selling stockholders;

gives effect to the conversion of 7,952,018 shares of series A convertible preferred stock held by TA Associates that were outstanding prior to this offering into 7,952,018 shares of common stock;

excludes restricted stock grants of approximately 90,200 shares of common stock that we intend to grant to certain employees and service providers at the closing of the initial public offering; and

excludes stock option grants that we intend to grant certain executive officers, employees and service providers on the day this offering is priced for sale to the public to purchase approximately 125,000 shares of common stock at the initial public offering price.



**Table of Contents****Summary Financial Data**

You should read the data set forth below in conjunction with our financial statements and related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations, Unaudited Pro Forma Financial Information and other financial information included elsewhere in this prospectus. We derived the summary financial data as of December 31, 2005 and 2006 and for each of the years ended December 31, 2004, 2005 and 2006 from our audited financial statements and the related notes appearing elsewhere in this prospectus. We derived the summary financial data as of December 31, 2004 from our audited financial statements and the related notes not included in this prospectus. We derived the summary financial data as of and for the years ended December 31, 2002 and 2003 from our unaudited financial statements not included in this prospectus. The summary statements of income data for the nine months ended September 30, 2006 and 2007 and the summary balance sheet data as of September 30, 2007 have been derived from our unaudited financial statements appearing elsewhere in this prospectus which, in the opinion of our management, have been prepared on the same basis as the audited financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of our operating results and financial position for those periods and as of those dates. The summary unaudited financial data for the nine months ended September 30, 2007 are not necessarily indicative of our results for the year ending December 31, 2007 and our historical results are not necessarily indicative of our results for any future period.

	Year Ended December 31,					Nine Months Ended	
	2002	2003	2004	2005	2006(1)	September 30, 2006(1)	September 30, 2007(1)
	(unaudited)	(unaudited)	(in thousands, except share and per share amounts)				
<b>Statement of Income Data</b>							
Net sales	\$ 65,382	\$ 100,866	\$ 171,766	\$ 244,947	\$ 332,060	\$ 247,219	\$ 299,797
Cost of sales	43,051	67,870	115,857	158,844	221,931	163,955	200,404
Gross profit	22,331	32,996	55,909	86,103	110,129	83,264	99,393
Selling, general and administrative expenses	17,545	29,566	48,461	67,900	88,716	64,611	85,491
Impairment loss on long-lived assets		955	293				
Operating income	4,786	2,475	7,155	18,203	21,413	18,653	13,902
Interest expense	160	218	429	638	722	548	607
Other (income) expense(2)	(318)	(428)	190	(96)	(368)	(303)	(168)
Income before income taxes	4,944	2,685	6,536	17,661	21,059	18,408	13,463
Provision for income taxes(3)	163	65	(1,450)	6,948	8,161	7,133	5,185
Net income	\$ 4,781	\$ 2,620	\$ 7,986	\$ 10,713	\$ 12,898	\$ 11,275	\$ 8,278
<b>Net income per common share:</b>							
Basic	\$ 0.32	\$ 0.17	\$ 0.53	\$ 0.71	\$ 0.86	\$ 0.75	\$ 0.55
Diluted	\$ 0.32	\$ 0.17	\$ 0.51	\$ 0.46	\$ 0.56	\$ 0.49	\$ 0.36

**Weighted average common shares outstanding(4):**



Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

Basic	15,000,100	15,000,100	15,000,100	15,000,100	15,000,100	15,000,100	15,000,100
Diluted	15,000,100	15,000,100	15,675,477	23,063,174	22,989,403	23,001,681	23,096,460

**Pro Forma Income  
Statement Data(5):**

Pro forma net income					\$ 13,022		\$ 10,142
Pro forma net income per common share:							
Basic					\$ 0.55		\$ 0.42
Diluted					\$ 0.54		\$ 0.42
Pro forma weighted average common shares outstanding:							
Basic					23,857,170		23,970,544
Diluted					23,905,730		24,145,892

**Table of Contents**

- (1) We adopted the provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123 (R), *Share-Based Payment* ( SFAS No. 123(R) ), using the prospective-transition method, effective January 1, 2006.
- (2) Includes interest income.
- (3) Effective December 1, 2004, we elected to be taxed as a C corporation for federal and state income tax purposes. Prior to this election, we were not subject to federal or certain state income taxation at the corporation level.
- (4) Share amounts as of December 31, 2002 and 2003 have been adjusted to reflect the December 2004 common stock dividend of 150,000:1 to Tom Sullivan, our founder and chairman of our board of directors.
- (5) The pro forma statement of income data for the year ended December 31, 2006 and nine months ended September 30, 2007 were derived from our Unaudited Pro Forma Financial Information included elsewhere in this prospectus.

	2002	2003	As of December 31,			2006	As of
	(unaudited)	(unaudited)	2004	2005	2006	2006	September 30,
			(in thousands)				2007
							(unaudited)
<b>Balance Sheet Data</b>							
Cash and cash equivalents	\$ 384	\$ 3,073	\$ 3,031	\$ 6,031	\$ 3,965	\$	5,666
Merchandise inventories	9,501	14,910	22,507	30,009	51,758		74,944
Total assets	13,249	21,017	39,753	55,162	78,020		106,395
Total debt and capital lease obligations, including current maturities	2,555	2,617	12,364	10,360	9,603		14,275
Stock compensation liability	850	2,020	4,958	8,092	9,132		12,034
Redeemable preferred stock			34,693	34,744	34,795		34,834
Total stockholder s equity (deficit)	4,260	3,620	(30,242)	(18,775)	(5,468)		4,108
Working capital(1)	4,299	5,230	8,091	17,059	29,697		24,686

**Pro Forma Balance Sheet****Data(2):**

Pro forma cash and cash equivalents							\$ 29,592
Pro forma total debt and capital lease obligations, including current maturities							\$ 189
Pro forma stock compensation liability							\$
Pro forma redeemable preferred stock							\$
Pro forma total stockholders equity (deficit)							\$ 87,892

(1) Working capital is defined as current assets minus current liabilities.

(2) The pro forma balance sheet data as of September 30, 2007 were derived from our Unaudited Pro Forma Financial Information included elsewhere in this prospectus.

	2002	2003	Year Ended December 31,			Nine Months Ended	
			2004	2005	2006	2006	September 30,
			(in thousands, except % and numbers of stores)				2007
<b>Operating Data</b>							
Number of stores open at end of period	25	40	57	76	91	85	111
Comparable store sales increase(1)(2)(3)	NA	22.9%	38.2%	19.0%	17.3%	19.2%	8.6%
Depreciation and amortization	\$ 1,033	\$ 883	\$ 1,157	\$ 2,240	\$ 2,908	\$ 2,118	\$ 2,605
Capital expenditures:							

Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

New store openings	\$ 22	\$ 112	\$ 225	\$ 352	\$ 225	\$ 174	\$ 559
Other(4)	371	410	6,322	3,975	2,494	1,900	4,197
Total capital expenditures	\$ 393	\$ 522	\$ 6,547	\$ 4,327	\$ 2,719	\$ 2,074	\$ 4,756

- (1) Stores are considered comparable on the first day of the thirteenth full calendar month of operation.
- (2) Comparable store sales data is not available for the year ended December 31, 2002 on the same basis as for subsequent periods.
- (3) Comparable store sales increase was 24.1% and 8.5% for the three months ended March 31, 2006 and 2007, 21.6% and 9.0% for the three months ended June 30, 2006 and 2007, 23.1% and 8.8% for the six months ended June 30, 2006 and 2007, and 12.8% and 8.4% for the three months ended September 30, 2006 and 2007, respectively.
- (4) Consists primarily of expenditures on expenses related to establishing our Toano facility (which opened in 2004), purchases of trailers, leasehold improvements, information technology and warehouse equipment.

**Table of Contents**

**RISK FACTORS**

*An investment in our common stock involves a high degree of risk. You should carefully consider the following information about these risks, together with the other information contained in this prospectus, before deciding to buy our common stock. Any of the risks we describe below could adversely affect our business, financial condition or operating results. The market price of our common stock could decline if one or more of these risks and uncertainties develop into actual events. You could lose all or part of your investment.*

**Risks Related to Our Business and Industry**

***The hardwood flooring industry depends on the economy, home remodeling activity, the homebuilding industry and other important factors.***

The hardwood flooring industry is highly dependent on the remodeling of existing homes and new home construction. In turn, remodeling and new home construction depend on a number of factors which are beyond our control, including interest rates, tax policy, employment levels, consumer confidence, credit availability, real estate prices, demographic trends, weather conditions, natural disasters and general economic conditions. If:

the national economy or any regional or local economy where we operate weakens;

interest rates rise;

credit becomes less available;

regions where we operate experience unfavorable demographic trends;

fuel costs or utility expenses increase; or

home-price appreciation slows;

that could limit discretionary consumer spending, reduce spending on remodeling of existing homes and cause purchases of new homes to decline. For example, although our net sales increased during 2006 and the first half of 2007, Catalina Research estimates that U.S. hardwood flooring square-foot sales declined 10.6% in 2006 and declined 14.1% in the first half of 2007 compared to the same period in 2006, principally as a result of decreased new housing demand. Any one or a combination of these factors could result in decreased demand for hard surface flooring, including in particular premium hardwood flooring, in remodeled and new homes, which would harm our business and operating results.

***The planned rapid increase in the number of our stores may make our future results unpredictable.***

As of September 30, 2007, we had 111 stores throughout the United States, 86 of which we opened after January 1, 2003. We plan to open at least 25 new stores in total during 2007 and between 30 and 40 new stores during each of the next several years thereafter. This growth strategy and the investment associated with the development of each new store may cause our operating results to fluctuate and be unpredictable or decrease our profits. Our future results will depend on various factors, including the successful selection of new markets and store locations, our ability to negotiate leases on acceptable terms, management of pre-opening expenses, the quality of our operations, consumer recognition of the quality of our products, our ability to meet customer demand, the continued popularity of hardwood flooring and general economic conditions. In addition, as we open more stores, our rate of expansion relative to the size of our store base will decline. We may not be able to identify suitable store locations in markets into which we seek to expand and may not be able to open as many stores as planned. Consumers in a new

market may be less familiar with our brands, and we may need to increase brand

## **Table of Contents**

awareness in that market through additional investments in advertising. Stores opened in new markets may have higher construction, occupancy or operating costs, or may have lower average store sales, than stores opened in the past. In addition, we may incur higher maintenance costs associated with our strategy of seeking out low-cost store locations than in the past. Newly opened stores may not succeed or may reach profitability more slowly than we expect, and the ramp-up to profitability may become longer in the future as we enter more mid-sized and smaller markets and add stores to larger markets where we already have a presence. Future markets and stores may not be successful and, even if we are successful, our average store sales and our comparable store sales may not increase at historical rates.

### ***Failure to manage our growth effectively could harm our business and operating results.***

Our plans call for a significant number of new stores, and increased sales from our website, call center and catalog. Our existing management information systems, including our store management systems and financial and management controls, may be unable to support our expansion. Managing our growth effectively will require us to continue to enhance these systems, procedures and controls and to hire, train and retain regional managers, store managers and store staff. In addition, we have hired a number of senior managers in 2006 and 2007, and execution of our strategy requires that they be integrated effectively. We may not respond quickly enough to the changing demands that our expansion will impose on our management, staff and existing infrastructure. Any failure to manage our growth effectively could harm our business and operating results.

### ***Our ability to produce hardwood flooring, particularly products made of more exotic species, depends on the continued availability of sufficient suitable hardwood.***

Our business strategy depends on offering a wide assortment of hardwood flooring to our customers. We sell flooring made from species ranging from domestic maple, oak and pine to imported cherry, ebony, mahogany and teak. Some of these species are scarce, and we cannot be assured of their continued availability, especially of exotic hardwoods that comprise a significant portion of our more profitable products. Our ability to obtain an adequate volume and quality of hard-to-find species depends on our suppliers' ability to furnish those species, which, in turn, could be affected by many things including events such as forest fires, insect infestation, tree diseases, prolonged drought and other adverse weather conditions. Government regulations relating to forest management practices also affect our suppliers' ability to harvest or export timber, and changes to regulations and forest management policies, or the implementation of new laws or regulations, could impede their ability to do so. For example, the U.S. Congress is currently considering legislation that might have the effect of restricting the supply of imported products. If our suppliers cannot deliver sufficient hardwood and we cannot find replacement suppliers, we would need to curtail finishing of the relevant product lines, which could cause our operating results to deteriorate.

### ***Our dependence on certain suppliers makes us vulnerable to the extent we rely on them.***

We rely on a concentrated number of suppliers for the majority of our supply needs. In 2006, one of our suppliers, Sequoia Floorings, accounted for approximately 14% of our purchases, and acted as agent for another of our suppliers, EPI, which accounted for another 7% of our purchases. Including those companies, our top 10 suppliers account for approximately 63% of our purchases in 2006. We generally do not have long-term contracts with our suppliers, and we typically obtain our hardwood supplies on an order-by-order basis, writing orders for future deliveries from 90 to 180 days before delivery. Our suppliers may be unable to supply us in the future due to various factors, which could include political instability in the supplier's country, a supplier's financial instability, inability or refusal to comply with applicable laws, trade restrictions or tariffs, insufficient transport capacity and other factors beyond our control. If we can no longer obtain merchandise from our major suppliers, or they refuse to continue to supply us on commercially reasonable terms or at all, and we cannot find replacement suppliers, we could experience a deterioration in our sales and operating results.

## **Table of Contents**

***If we fail to identify and develop relationships with a sufficient number of qualified mills, our ability to obtain hardwood products that meet our high quality standards could be harmed.***

We purchase flooring directly from mills located around the world. We believe that these direct supplier relationships are relatively unique in our industry. In order to retain the competitive advantage that we believe results from these relationships, we need to continue to identify, develop and maintain relationships with qualified mills that can satisfy our high standards for quality and our requirements for hardwood in a timely and efficient manner. The need to develop new relationships will be particularly important as we seek to expand our operations in the future. Any inability to do so could reduce our competitiveness, slow our plans for further expansion and cause our sales and operating results to deteriorate.

***Our ability to obtain hardwood from abroad and the operations of many of our international suppliers are subject to risks that are beyond our control and that could harm our operations.***

We rely on a select group of international suppliers to provide us with hardwood products that meet our specifications. In 2006, approximately 30% of our product was sourced from Asia, approximately 24% was sourced from South America and approximately 11% was sourced from other locations outside of North America. As a result, we are subject to risks associated with obtaining products from abroad, including:

political unrest, terrorism and economic instability resulting in the disruption of trade from foreign countries where our products originate;

currency exchange fluctuations;

the imposition of new laws and regulations, including those relating to environmental matters; imports, duties, taxes and other charges on exports or imports; labor conditions; quality and safety standards; trade restrictions; and restrictions on funds transfers;

disruptions or delays in shipments; and

changes in local economic conditions in countries where our suppliers are located.

These and other factors beyond our control could disrupt the ability of our suppliers to ship certain products to us cost-effectively or at all, which could harm our operations.

***Increased hardwood costs could harm our results of operations.***

The cost of the various species of hardwood that we use in our products is important to our profitability. Hardwood lumber costs fluctuate because of changes in domestic and international supply and demand, labor costs, competition, market speculation, product availability, environmental restrictions, government regulation and trade policies, weather conditions, processing and freight costs and delivery delays. We generally do not have long-term supply contracts or guaranteed purchase amounts. As a result, we may not be able to anticipate or react to changing hardwood costs by adjusting our purchasing practices, and we may not always be able to increase the selling prices of our products in response to increases in supply costs. If we cannot address changing hardwood costs appropriately, it could cause our operating results to deteriorate.

***Increased delivery costs, particularly those relating to the cost of fuel, could harm our results of operations.***

We source merchandise from around the world, and our cost of sales includes the cost of delivery to our Toano facility. In addition, we rely on third-party trucking companies to transport our products from our Toano facility to our stores and from our stores to our customers. If the cost of fuel or other





## **Table of Contents**

costs, such as import tariffs, rise, it could result in increases in our cost of sales and selling, general and administrative expenses due to additional delivery charges and in the fees transportation companies charge us to transport our products to our stores and customers. We may be unable to increase the price of our products to offset increased delivery charges, which could cause our operating results to deteriorate.

### ***If our management information systems experience disruptions, it could disrupt our business and reduce our sales.***

We depend on our management information systems to integrate the activities of our stores, website and call center, to process orders, to respond to customer inquiries, to manage inventory, to purchase merchandise and to sell and ship goods on a timely basis. Our high growth rate creates additional challenges in maintaining and expanding our systems. We may experience operational problems with our information systems as a result of system failures, viruses, computer hackers or other causes. We have identified improvements that we need to make to our internal controls that relate to limiting access to our information systems, which we expect to implement over the next 12 months. Any significant disruption or slowdown of our systems, including a disruption or slowdown caused by our failure to successfully upgrade our systems, could cause information, including data related to customer orders, to be lost or delayed, which could result in delays in the delivery of products to our stores and customers or lost sales. During 2007, we are introducing two new management information systems:

In the first quarter of 2007, we upgraded our entire corporate network, including our telephone lines, to an Internet-based network. If our network is disrupted, we may experience delayed communications within our operations and between our customers and ourselves, and may not be able to communicate at all via our network, including via telephones connected to our network.

Before the end of 2007, we plan to introduce a new point-of-sale system to improve the tracking of inventory and sales information in all of our stores. If the introduction of this system interferes with our existing system, we could experience disruptions in our ability to stock our stores and fulfill customer orders in a timely manner.

Moreover, we may in the future be unable to develop or acquire technology that meets our needs or those of our customers, or have insufficient resources to make necessary investments in technology. Accordingly, if our information systems are inadequate to handle our growth or if changes in technology cause our information systems to become obsolete, it could disrupt or otherwise harm our operations.

### ***Any disruption of our website or our call center could disrupt our business and lead to reduced sales and reputational damage.***

Our website and our call center are integral parts of our integrated multi-channel strategy. Customers use our website and our call center as information sources on the range of products available to them and to order our products, samples or catalogs. Our website in particular is vulnerable to certain risks and uncertainties associated with the Internet, including changes in required technology interfaces, website downtime and other technical failures, security breaches and consumer privacy concerns. If we cannot successfully maintain our website and call center in good working order, it could reduce our sales and damage our reputation.

### ***Our success depends substantially upon the continued retention of certain key personnel.***

We believe that our success has depended and continues to depend to a significant extent on the efforts and abilities of our senior management team and our board of directors. Our failure to retain members of that team could impede our ability to build on the efforts they have undertaken with respect

## **Table of Contents**

to our business. Specifically, the loss of Tom Sullivan, our founder and the chairman of our board of directors, could harm us. Under his guidance, we experienced rapid growth and established ourselves as a leading company in the industry. Tom continues to have an active role in determining our strategic direction and assisting with our day-to-day operations, and we believe that if we no longer had access to his product knowledge and relationships with our suppliers, it would eliminate an important competitive advantage. In addition, the loss of Jeff Griffiths, our president and chief executive officer, or Dan Terrell, our chief financial officer, could harm us, as we rely on their significant experience with reporting companies and the retail industry.

### ***Our success depends upon our ability to attract, train and retain highly qualified managers and staff.***

Our success depends in part on our ability to attract, hire, train and retain qualified managers and staff. Buying hardwood flooring is an infrequent event, and typical consumers have very little knowledge of the range, characteristics and suitability of the products available to them before starting the purchasing process. Therefore, consumers in the hardwood flooring market expect to have sales associates serving them who are knowledgeable about the entire assortment of products offered by the retailer and the process of choosing and installing hardwood flooring. As a result, competition for qualified store managers and sales associates among flooring retailers is intense. We may not succeed in attracting and retaining the personnel we require to conduct our current operations and support our potential future growth. In addition, as we expand into new markets, we may find it more difficult to hire, motivate and retain qualified employees.

### ***Increased competition could cause price declines, decrease demand for our products and decrease our market share.***

We operate in the hardwood flooring industry, which is highly fragmented and competitive. We face significant competition from multinational home improvement chains, national and regional flooring specialty chains, Internet-based companies and privately-owned single-site enterprises. We compete on the basis of price, customer service, store location and range, quality and availability of hardwood flooring we offer our customers. Our competitive position is also influenced by the availability, quality and cost of merchandise, labor costs, finishing, distribution and sales efficiencies and our productivity compared to that of our competitors. As we expand into new and unfamiliar markets, we may experience different competitive conditions than in the past.

Some of our competitors are larger organizations, have existed longer, are more diversified in the products they offer and have a more established market presence with substantially greater financial, marketing, personnel and other resources than we have. In addition, our competitors may forecast market developments more accurately than we do, develop products that are superior to ours or produce similar products at a lower cost, or adapt more quickly to new technologies or evolving customer requirements than we do. Intense competitive pressures from one or more of our competitors could cause price declines, decrease demand for our products and decrease our market share.

Hardwood flooring may become less popular as compared to other types of floor coverings in the future. For example, our products are made using various hardwood species, including rare exotic hardwood species harvested from rainforests, and concern over the environmental impact of tree harvesting could shift consumer preference towards synthetic or inorganic flooring. In addition, hardwood flooring competes against carpet, vinyl sheet, vinyl tile, ceramic tile, natural stone and other types of floor coverings. If consumer preferences shift towards types of floor coverings other than hardwood flooring, we may experience decreased demand for our products.

All of these competitive factors may harm us and reduce our sales and profits.

**Table of Contents**

***Damage, destruction or disruption of our Toano finishing and distribution facility could significantly impede our ability to finish and distribute our products.***

We currently finish approximately 70% of all Bellawood products at our Toano finishing facility. In 2006, Bellawood flooring accounted for approximately one-third of our net sales. We also finish small quantities of certain of our other products there. The Toano facility also serves as our distribution center, and approximately 85% of our merchandise passes through this facility before we move it to our stores. The Toano facility also houses our primary computer systems, which control our management information and inventory management systems, and our corporate headquarters. We do not have any other finishing or distribution facilities. If the Toano facility or our inventory held there were damaged or destroyed by fire, wood infestation or other causes, our entire finishing and distribution processes would be disrupted, which could cause significant lost production and delays in delivery. This could impede our ability to stock our stores and deliver products to our customers, and cause our sales and operating results to deteriorate.

***Failure to maintain relevant product endorsement agreements and product placement arrangements could harm our reputation and cause our sales to deteriorate.***

We have established relationships with well-known and respected home improvement celebrities to evaluate, promote and help establish with consumers the high-quality nature of our products. If these individuals were to stop promoting our products, if we were unable to renew our endorsement contracts with them or if we could not find other endorsers of a similar caliber, our sales and reputation could be harmed. Similarly, any actions that persons endorsing our products may take, whether or not associated with our products, which harm their or our reputations could also harm our brand image with consumers and our reputation, and cause our sales to deteriorate. We also have a number of product placement arrangements with home improvement-related television shows. We rely on these arrangements to increase awareness of our brands, and to enable potential customers to see both what our flooring will look like after installation and the relative ease with which it can be installed. Any failure to continue these arrangements could cause our brands to become less well-known and cause our sales to deteriorate.

***Our success depends on the continued effectiveness of our advertising strategy.***

We believe that our past success was achieved in part through our successful investment in local and national advertising. We typically locate our stores in industrial or commercial areas that have lower rents than traditional retail locations, but that are generally set some distance from population centers and downtown urban areas. To support this real estate strategy, we have used extensive advertising to encourage customers to drive to our stores. We may need to increase our advertising expense to support our business strategy in the future. In addition, we lease but do not own the rights to 1-800-FLOORING. Although we have an indefinite renewal right under the related contract, it could be terminated in certain circumstances, which could increase our costs until we were able to publicize a new toll-free number. If our advertisements fail to draw customers in the future, or if the cost of advertising or other marketing materials increases significantly, we could experience declines in our sales and operating results.

***We have entered into a number of lease agreements with companies controlled by our controlling shareholder, which may make it more difficult to modify or terminate those leases.***

We have entered into several agreements with related parties in connection with a significant number of transactions, including leases for our Toano facility, which includes a store location, and 26 of our other store locations as of September 30, 2007. Tom Sullivan is the sole owner of ANO LLC, with which we have in the past entered into most such agreements. In addition, Tom is the sole owner of DORA Real Estate Company, LLC and Wood on Wood Road, Inc., and has a 50% membership interest in

## **Table of Contents**

BMT Holdings, LLC, and we lease one store location from each of these entities. While we believe that these leases we have signed to date are on fair market terms and that the stockholders' agreement to which Tom and TA Associates are parties prevents entities affiliated with Tom from setting lease rates above market rates, it may be more difficult for us to modify or terminate those leases in the future, or we may be prevented from doing so by the actions of Tom, who will continue to be a significant shareholder following this offering. See **Certain Relationships and Related Party Transactions** **Store Lease Arrangements**.

### ***We will incur non-cash compensation expenses, and may be required to issue shares of common stock, in connection with existing stock-based compensation agreements.***

In connection with this offering, Kevin Sullivan, Tom's brother, who started our western U.S. operations and was our first regional manager, will receive shares of our common stock, to be contributed by Tom and which have been placed in escrow, pursuant to the Variable Plan, an agreement between Tom and Kevin that we have guaranteed. The number of shares to be delivered depends upon a calculation of the value of our western U.S. sales region. While the agreement provides that the number of shares will be fixed in connection with this offering, if the parties disagree on the calculation, the number of shares may need to be adjusted in the future, which could require us to record an additional non-cash stock compensation liability expense. We do not know what the magnitude would be of any such future non-cash compensation expense. We recorded a non-cash compensation expense relating to this matter of \$2.9 million in the first nine months of 2007, \$1.0 million in 2006, \$3.1 million in 2005 and \$2.9 million in 2004, and as of September 30, 2007 carried a short-term liability of \$12.0 million on our balance sheet relating to this agreement.

A former senior executive filed a demand for arbitration in connection with his resignation of employment in May 2006. That executive alleges that he terminated his employment for good reason, as defined in his employment agreement and our warrant plan, based on an allegedly substantial reduction in his responsibilities. In his demand for arbitration, the former senior executive contends that we breached our obligations to him upon his resignation of employment. He is seeking damages of approximately \$0.7 million (plus the value of certain other specified benefits), as well as a declaration that he has owned 1% of the company since he terminated his employment. An arbitration hearing was held on October 1-2, 2007. The parties will be afforded the opportunity to submit post-arbitration briefs and additional testimony and evidence may be presented. We could be required to pay damages and issue additional shares of stock to the former senior executive in the arbitration if we are found to be liable for those obligations.

### ***We may not be able to adequately protect our intellectual property, which could harm the value of our brands and harm our business.***

Our intellectual property is material to the conduct of our business. Our ability to implement our business plan successfully depends in part on our ability to further build brand recognition using our trademarks, service marks and other proprietary intellectual property, including our name and logo and the names of our brands. If our efforts to protect our intellectual property are inadequate, or if any third party infringes on or misappropriates our intellectual property, either in print or on the Internet, the value of our brands may be harmed, which could adversely affect our business and might prevent our brands from achieving or maintaining market acceptance. We may also encounter claims from prior users of similar intellectual property in locales where we operate or intend to operate. This could harm our image, brand or competitive position and cause us to incur significant penalties and costs.

### ***Environmental, health and safety laws and regulations could increase the cost of doing business or restrict our ability to conduct our business.***

We are subject to a wide range of general and industry-specific environmental, health and safety and other laws and regulations imposed by federal, state and local authorities, including those governing the use, storage, handling, generation, treatment, emission, release, discharge and disposal of certain

## **Table of Contents**

hazardous materials and wastes, the remediation of contaminated soil and groundwater and the health and safety of employees. If we are unable to extend or renew a material approval, license or permit required by such laws, or if there is a delay in renewing any material approval, license or permit, that may cause our sales and operating results to deteriorate or otherwise harm our business.

***We will incur increased costs and be required to carry out activities we have not previously undertaken as a result of becoming a public company.***

As a public company, we will incur significant legal, accounting and other expenses that we did not incur as a private company. The Sarbanes-Oxley Act of 2002 and related rules of the SEC and the New York Stock Exchange regulate corporate governance practices of public companies. Complying with these requirements will likely increase our costs and make some activities more time-consuming. For example, we will need to adopt new internal controls and disclosure controls and procedures and create new board committees, and also expect to modify director compensation and possibly to increase the number of directors. We will also incur additional expenses associated with our SEC reporting requirements. A number of those requirements will require us to carry out activities we have not previously undertaken. For example, under Section 404 of the Sarbanes-Oxley Act, for our annual report on Form 10-K for 2008 we will need to document and test our internal control procedures, our management will need to assess and report on our internal control over financial reporting and our independent registered public accounting firm will need to issue an opinion on the effectiveness of those controls. If we identify any issues in complying with those requirements (for example, if a material weakness was identified in our internal control over financial reporting), we could also incur additional costs rectifying those issues, and their existence could impact our reputation or investor perceptions of us or otherwise harm our business. We are currently not aware of any material weaknesses in our internal controls or disclosure controls. In addition, we expect that it will be difficult and expensive to obtain director and officer liability insurance. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers. Advocacy efforts by shareholders and third parties may also prompt even more changes in governance and reporting requirements. We cannot predict or estimate the amount of additional costs we may incur or the timing of such costs.

## **Risks Relating to Our Common Stock and This Offering**

***There is no existing market for our common stock and we do not know if one will develop. Even if a market does develop, the stock prices in the market may not exceed the offering price.***

Prior to this initial public offering, there has not been a public market for our common stock. We cannot predict the extent to which investor interest in our company will lead to the development of an active trading market on the New York Stock Exchange or otherwise, or how liquid that market may become. If an active trading market does not develop, you may have difficulty selling any shares that you buy. In addition, the initial public offering price for the common stock was determined by negotiations between us and the representatives of the underwriters and may not be indicative of prices that will prevail in the open market following this offering. Consequently, you may not be able to sell shares of our common stock at prices equal to or greater than the price you pay in this offering.

***Tom Sullivan and TA Associates will have the ability to exercise significant influence over us after this offering, and their interests in our business may be different than yours.***

All of the issued and outstanding shares of our common stock are currently owned by Tom Sullivan, while TA Associates indirectly beneficially owns all of our outstanding series A convertible preferred stock. Assuming that TA Associates converts all of its preferred stock into common stock and that the underwriters do not exercise their option to purchase additional shares, upon completion of this offering, Tom will control approximately 37%, and TA Associates will control approximately 22%, of our outstanding common stock, which also reflects the transfer of an estimated 926,000 shares from Tom

## **Table of Contents**

to Kevin Sullivan pursuant to the Variable Plan. Accordingly, each of these parties will be able to exercise significant influence over our business policies and affairs and all matters requiring a stockholders' vote, including the composition of our board of directors, the adoption of amendments to our certificate of incorporation and the approval of mergers or sales of all or substantially all of our assets. This concentration of ownership could also delay, defer or even prevent a change in control of our company and may make some transactions more difficult or impossible without their support. These interests of these stockholders may conflict with yours, and they may seek to cause us to take courses of action that, in their judgment, could enhance their investment in us, but which might involve risks to holders of our common stock or be harmful to our business or other investors.

### ***Our anti-takeover defense provisions may cause our common stock to trade at market prices lower than it might absent such provisions.***

We intend to amend our certificate of incorporation and bylaws in connection with this offering. Our new certificate of incorporation and bylaws will contain several provisions that may make it more difficult or expensive for a third party to acquire control of us without the approval of our board of directors. These provisions include a staggered board, the availability of blank check preferred stock, provisions restricting stockholders from calling a special meeting of stockholders or requiring one to be called or from taking action by written consent and provisions that set forth advance notice procedures for stockholders' nominations of directors and proposals of topics for consideration at meetings of stockholders. Our certificate of incorporation will also provide that Section 203 of the Delaware General Corporation Law, which relates to business combinations with interested stockholders, will apply to us. These provisions may delay, prevent or deter a merger, acquisition, tender offer, proxy contest or other transaction that might otherwise result in our shareholders receiving a premium over the market price for their common stock. In addition, these provisions may cause our common stock to trade at a market price lower than it might absent such provisions.

### ***Our common stock price may be volatile and you may lose all or part of your investment.***

The market price of our common stock could fluctuate significantly, and you may not be able to resell your shares at or above the offering price. Those fluctuations could be based on various factors in addition to those otherwise described in this prospectus, including:

our operating performance and the performance of our competitors;

the public's reaction to our press releases, our other public announcements and our filings with the SEC;

changes in earnings estimates or recommendations by research analysts who follow Lumber Liquidators or other companies in our industry;

variations in general economic conditions;

the number of shares to be publicly traded after this offering;

actions of our current shareholders, including sales of common stock by our directors and executive officers;

the arrival or departure of key personnel; and

other developments affecting us, our industry or our competitors.

## Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

In addition, in recent years the stock market has experienced significant price and volume fluctuations. These fluctuations may be unrelated to the operating performance of particular companies but may cause declines in the market price of our common stock. The price of our common stock could fluctuate based upon factors that have little or nothing to do with our company or its performance.

**Table of Contents**

***Purchasers in this offering will experience immediate and substantial dilution.***

Prior investors have paid substantially less per share than the price in this offering. The initial public offering price is substantially higher than the net tangible book value per share of the outstanding common stock immediately upon completion of this offering. As a result, investors purchasing our common stock in this offering will incur immediate dilution of \$7.75 per share. The exercise of outstanding options and future equity issuances at prices below the initial public offering price would result in further dilution to purchasers in this offering.

***Future sales of our common stock, or the perception that such sales may occur, could cause our stock price to fall.***

Sales of substantial amounts of our common stock in the public market after the consummation of this offering, or the perception that such sales may occur, could harm the market price of our common stock and could materially impair our ability to raise capital in the future through offerings of our common stock.

We, our executive officers and directors and the selling stockholders have agreed, subject to certain exceptions, not to dispose of or hedge any common stock or securities convertible into or exchangeable for shares of common stock during the period from the date of this prospectus continuing through the date 180 days after the date of this prospectus, except, in our case, for the issuance of common stock upon exercise of options outstanding under existing option plans. Goldman, Sachs & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated may, in their sole discretion, release any of these shares from these restrictions at any time without notice.

All of our shares of common stock outstanding as of the date of this prospectus may be sold in the public market by existing stockholders 180 days after the date of this prospectus, subject to applicable volume and other limitations imposed under federal securities laws. See [Shares Eligible for Future Sale](#) for a more detailed description of the restrictions on selling shares of our common stock upon completion of this offering.

***We do not intend to pay dividends for the foreseeable future.***

For the foreseeable future, we intend to retain any earnings to finance the development and expansion of our business, and we do not anticipate paying any cash dividends on our common stock. Accordingly, investors must be prepared to rely on sales of their common stock after price appreciation to earn an investment return, which may never occur. Investors seeking cash dividends should not purchase our common stock. Any determination to pay dividends in the future will be made at the discretion of our board of directors and will depend on our results of operations, financial condition, contractual restrictions, restrictions imposed by applicable law and other factors our board deems relevant. See [Dividend Policy](#).



**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

Some of the statements contained in this prospectus constitute forward-looking statements. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts, such as statements regarding our future financial condition or results of operations, our prospects and strategies for future growth, the development and introduction of new products, and the implementation of our marketing and branding strategies. In many cases, you can identify forward-looking statements by terms such as *may*, *will*, *should*, *expects*, *plans*, *anticipates*, *believes*, *estimates*, *predicts*, *potential* or the negative of these terms or other comparable terminology.

The forward-looking statements contained in this prospectus reflect our current views about future events and are subject to risks, uncertainties, assumptions and changes in circumstances that may cause events or our actual activities or results to differ significantly from those expressed in any forward-looking statement. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future events, results, actions, levels of activity, performance or achievements. Readers are cautioned not to place undue reliance on these forward-looking statements. A number of important factors could cause actual results to differ materially from those indicated by the forward-looking statements, including, but not limited to, those factors described in *Risk Factors* and *Management's Discussion and Analysis of Financial Condition and Results of Operations*. These factors include, without limitation:

our ability to continue to increase comparable store sales;

our ability to add new stores;

our ability to manage our growth effectively;

our ability to develop and maintain effective internal controls;

increased competition causing us to reduce the prices of our products or to increase significantly our marketing efforts in order to avoid losing market share;

changes in consumer preferences or the reduction in demand for hardwood flooring;

our ability to accurately forecast consumer demand for our products;

failure of our suppliers to produce or deliver merchandise to us in a timely or cost-effective manner;

our ability to accurately anticipate and respond to seasonal or quarterly fluctuations in our operating results;

the availability and effective operation of management information systems and other technology;

our ability to attract and maintain the services of our senior management and key employees; and

changes in general economic or market conditions, including as a result of political or military unrest or terrorist attacks. The forward-looking statements contained in this prospectus reflect our views and assumptions only as of the date of this prospectus. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

**Table of Contents**

**USE OF PROCEEDS**

We estimate that the net proceeds to us from our sale of 3,800,000 shares of common stock in this offering, after deducting underwriting discounts, commissions and estimated offering expenses payable by us, will be approximately \$36.4 million. We will not receive any proceeds from the sale of shares by the selling stockholders. In addition, we will not participate in the sale of additional shares relating to the underwriters' option to purchase additional shares from the selling stockholders. The chairman of our board of directors is selling shares of common stock in this offering. See "Principal and Selling Stockholders."

We intend to repay all amounts outstanding under the term-loan portion of our senior secured loan agreement and our new revolving credit agreement (approximately \$14.1 million in aggregate as of September 30, 2007) using proceeds from this offering. The term-loan portion of our senior secured loan agreement, which is scheduled to mature in 2011, bears interest at a per annum rate approximately equal to one-month LIBOR (floating daily) plus 0.90%, or 6.0% as of September 30, 2007. The new revolving credit agreement bears interest at a per annum rate approximately equal to one-month LIBOR (reset on the 10<sup>th</sup> of the month) plus 0.50%, or 6.3% as of September 30, 2007. We currently intend to use any future borrowings under the new revolving credit agreement for working capital purposes.

After repayment in full of the amounts outstanding under our senior secured loan agreement, we intend to use the remainder of the net proceeds of the offering to provide additional long-term capital to support the growth of our business and for general corporate purposes. The amounts and timing of our actual expenditures will depend on numerous factors, including the status of our expansion efforts; sales, advertising and marketing activities; and our need to expand our finishing and distribution facility. Accordingly, our management will have broad discretion in the application of the net proceeds, and investors will be relying on the judgment of our management regarding the application of the proceeds from this offering.

**DIVIDEND POLICY**

We currently anticipate that we will retain any future earnings for use in our business. As a result, we do not anticipate paying any cash dividends in the foreseeable future.

In connection with our sale of shares of our series A convertible preferred stock to TA Associates in December 2004, we implemented a 150,000 to 1 stock split relating to our common stock, which we effected by means of a stock dividend to our sole shareholder, Tom Sullivan, our founder and chairman of our board of directors. The stock split was effected prior to the transaction in order to increase the number of common shares held by Tom from 100 to approximately 15.0 million. The stock split was effected in order to ensure that Tom would continue to hold an appropriate percentage of our common stock upon conversion of the convertible preferred stock held by TA Associates, and the extent of the split was determined in connection with the sale of shares of preferred stock (which is convertible into common stock on a one-to-one basis). We distributed 15,000,000 shares to Tom in connection with the stock split. We also distributed \$42.6 million in cash to Tom in 2004, including \$30.0 million of the proceeds from the sale of the convertible preferred stock (which represented a significant dilution of his ownership interest), \$5.0 million to enable him to pay taxes on deemed income during the period we were an S corporation and \$7.6 million of additional cash. We retained cash not distributed to Tom from the sale of our series A convertible preferred stock to provide us with sufficient capital for operating liquidity. Tom, as our sole shareholder and sole director, approved both the stock split and the cash distributions.

**Table of Contents****CAPITALIZATION**

The following table sets forth our capitalization as of September 30, 2007 on both an actual basis and on a pro forma basis to reflect:

the sale by us of common stock in this offering at an initial public offering price of \$11.00 per share and after deducting underwriting discounts and commissions and estimated offering expenses payable by us;

the repayment of all amounts outstanding (approximately \$14.1 million in aggregate as of September 30, 2007) under the term-loan portion of our senior secured loan agreement and our new revolving credit agreement;

the conversion of 7,952,018 shares of series A convertible preferred stock held by TA Associates that were outstanding prior to this offering into 7,952,018 shares of common stock;

the grant of approximately 90,200 shares of restricted common stock to certain employees and service providers, reflecting shares that we intend to grant to such persons at the closing of the initial public offering;

the grant of stock options that we intend to grant to certain executive officers, employees and service providers on the day that this offering is priced for sale to the public to purchase approximately 125,000 shares of common stock at the initial public offering price;

the expected satisfaction of the stock compensation liability associated with the Variable Plan, which includes a guarantee by us, through the transfer of shares of common stock from Tom Sullivan to Kevin Sullivan; and

the non-cash compensation expense associated with the regional manager stock unit plan and acceleration of non-cash compensation expense under the 2004 and 2006 stock option plans.

You should read this table in conjunction with the sections of this prospectus captioned Use of Proceeds, Selected Financial Data, Management's Discussion and Analysis of Financial Condition and Results of Operations and Unaudited Pro Forma Financial Information as well as the audited financial statements and related notes included elsewhere in this prospectus.

	<b>As of September 30, 2007</b>	
	<b>Actual</b>	<b>Pro Forma</b>
	<b>(in millions, except share amounts)</b>	
Cash and cash equivalents	\$ 5.7	\$ 29.6
Total debt and capital lease obligations, including current maturities	\$ 14.3	\$ 0.2
Redeemable preferred stock	34.8	
Stockholders' equity:		
Common stock, par value \$0.001; 35,000,000 shares authorized; 15,000,100 and 26,752,118 issued and outstanding, respectively		
Additional capital	2.5	87.1
Retained earnings	1.6	0.8

Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

Total stockholders' equity		4.1	87.9
Total capitalization		\$ 53.2	\$ 88.1

**Table of Contents**

**DILUTION**

If you invest in our common stock, your ownership interest will be diluted by the amount by which the initial offering price per share paid by the purchasers of common stock in this offering exceeds the net tangible book value per share of our common stock following this offering. As of September 30, 2007, our net tangible book value was approximately \$3.1 million, or \$0.20 per share of common stock. Net tangible book value per share equals total tangible assets minus total liabilities and the series A convertible preferred stock divided by the number of shares of our common stock outstanding.

Our pro forma net tangible book value as of September 30, 2007 would have been approximately \$86.8 million, or \$3.25 per share of common stock, after giving effect to:

the sale by us of common stock in this offering, at an initial public offering price of \$11.00 per share and after deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us;

the repayment of all amounts outstanding (approximately \$14.1 million in aggregate as of September 30, 2007) under the term-loan portion of our senior secured loan agreement and our new revolving credit agreement;

the conversion of 7,952,018 shares of series A convertible preferred stock held by TA Associates that were outstanding prior to this offering into 7,952,018 shares of common stock;

the expected satisfaction of the stock compensation liability associated with the Variable Plan, which includes a guarantee by us, through the transfer of shares of common stock from Tom to Kevin; and

the non-cash compensation expense associated with the regional manager stock unit plan and acceleration of non-cash compensation expense under the 2004 and 2006 stock option plans.

This represents an immediate increase in the net tangible book value of \$3.05 per share to existing stockholders and an immediate dilution in the net tangible book value of \$7.75 per share to the investors who purchase our common stock in this offering at the initial public offering price. Sales of shares by our selling stockholders in this offering do not affect our net tangible book value. The following table illustrates this per-share dilution:

Initial public offering price per share	\$11.00
Net tangible book value per share as of September 30, 2007	\$ 0.20
Increase in net tangible book value per share attributable to conversion of the series A convertible preferred stock	1.45
Increase in net tangible book value per share attributable to this offering	1.60
<b>Pro forma net tangible book value per share after this offering</b>	<b>3.25</b>
Dilution per share to new investors in this offering	\$7.75

**Table of Contents**

The following table summarizes, on a pro forma basis, as of September 30, 2007, the difference between existing stockholders and new investors with respect to the number of shares of common stock purchased from us, the total consideration paid to us for these shares and the average price per share paid by our existing stockholders and to be paid by the new investors in this offering. The calculation below reflects the effect of shares purchased by new investors at an initial public offering price of \$11.00 per share, before deducting underwriting discounts and commissions and estimated offering expenses payable by us.

	Shares Purchased		Total Consideration		Average Price
	Number	Percent	Amount	Percent	Per Share
Existing stockholders	22,952,118	85.8%	\$ 34,988,879	45.6%	\$ 1.52
New investors	3,800,000	14.2%	\$ 41,800,000	54.4%	\$ 11.00
<b>Total</b>	<b>26,752,118</b>	<b>100.0%</b>	<b>\$ 76,788,879</b>	<b>100.0%</b>	<b>\$ 2.87</b>

The share information in the tables above excludes:

1,846,847 shares of common stock issuable upon exercise of outstanding stock options with a weighted average exercise price of \$7.76 per share, of which 261,260 shares had vested as of September 30, 2007;

the grants of approximately 90,200 shares of restricted common stock that we intend to grant to certain employees and service providers at the closing of the initial public offering; and

stock option grants that we intend to grant certain executive officers, employees and service providers on the day this offering is priced for sale to the public to purchase 125,000 shares of common stock at the initial public offering price. If outstanding options are exercised, new investors will experience further dilution.

**Table of Contents**

**UNAUDITED PRO FORMA FINANCIAL INFORMATION**

The unaudited pro forma balance sheet as of September 30, 2007 gives pro forma effect to the following transactions as if they each occurred on September 30, 2007 and the unaudited pro forma income statement for the year ended December 31, 2006 and for the nine months ended September 30, 2007 gives pro forma effect to the following transactions as if they occurred on January 1, 2006:

the sale by us of common stock in this offering, at an initial public offering price of \$11.00 per share and after deducting the underwriting discounts and commissions and estimated offering expenses payable by us;

the repayment of all amounts outstanding under the term-loan portion of our senior secured loan agreement and our new revolving credit facility;

the conversion of 7,952,018 shares of series A convertible preferred stock held by TA Associates that were outstanding prior to this offering into 7,952,018 shares of common stock;

the grant of approximately 90,200 shares of restricted common stock to certain employees and service providers, reflecting shares that we intend to grant to such persons at the closing of the initial public offering;

stock option grants that we intend to grant certain executive officers, employees and service providers on the day this offering is priced for sale to the public to purchase approximately 125,000 shares of common stock at the initial public offering price;

the expected satisfaction of the stock compensation liability associated with the Variable Plan, which includes a guarantee by us, through the transfer of shares of common stock from Tom to Kevin; and

the non-cash compensation expense associated with the regional manager stock unit plan and acceleration of non-cash compensation expense under the 2004 and 2006 stock option plans.

The unaudited pro forma financial information is presented for informational purposes only and does not purport to represent what our results of operations would actually have been if the transactions had occurred on the dates indicated nor do they purport to project our results of operations for any future period.

You should read our unaudited pro forma financial statements and the accompanying notes in conjunction with all of the historical financial statements and related notes included in this prospectus and other financial information appearing elsewhere in this prospectus, including information contained in Capitalization and Management's Discussion and Analysis of Financial Condition and Results of Operations.



**Table of Contents**

**Lumber Liquidators, Inc.**  
**Unaudited Pro Forma Balance Sheet**  
(in thousands)

	As of September 30, 2007		
	Actual	Offering Adjustments	Pro Forma
<b>Assets</b>			
Current assets:			
Cash and cash equivalents	\$ 5,666	\$ 23,926	\$ 29,592
Merchandise inventories	74,944		74,944
Prepaid expenses	3,172		3,172
Other current assets	3,410	1,687	5,097
<b>Total current assets</b>	<b>87,192</b>	<b>25,613</b>	<b>112,805</b>
Property and equipment, net	11,381		11,381
Deferred income taxes	5,337	(4,181)	1,156
Other assets	2,485		2,485
<b>Total assets</b>	<b>\$ 106,395</b>	<b>\$ 21,432</b>	<b>\$ 127,827</b>
<b>Liabilities and Stockholders Equity</b>			
Current liabilities:			
Accounts payable	\$ 20,740	\$	\$ 20,740
Customer deposits and store credits	10,184		10,184
Stock compensation liability	12,034	(12,034)	
Accrued compensation	2,580		2,580
Other current liabilities	7,640	(1,398)	6,242
Current portion of long-term debt and capital lease obligations	9,328	(9,146)	182
<b>Total current liabilities</b>	<b>62,506</b>	<b>(22,578)</b>	<b>39,928</b>
Long-term debt and capital lease obligations	4,947	(4,940)	7
Redeemable preferred stock	34,834	(34,834)	
Stockholders equity	4,108	83,784	87,892
<b>Total liabilities and stockholders equity</b>	<b>\$ 106,395</b>	<b>\$ 21,432</b>	<b>\$ 127,827</b>

*See accompanying notes to unaudited pro forma balance sheet*

**Table of Contents****Notes to Unaudited Pro Forma Balance Sheet**

Set forth below are the estimated sources and uses of funds pertaining to this offering.

<b>Sources</b>	<b>(in thousands)</b>
Proceeds from offering of common stock, net of estimated fees and expenses	\$ 36,374
Total sources	\$ 36,374
<b>Uses</b>	
Repayment of all amounts outstanding under the term-loan portion and the revolving facility portion of our senior secured loan agreement (approximately \$14.1 million in aggregate as of September 30, 2007)	\$ 14,086
Cash available for general corporate purposes	22,288
Total uses	\$ 36,374

This offering is expected to raise proceeds of \$36.4 million (net of estimated fees and expenses) to us. Had the offering occurred on September 30, 2007, it would have had the following effect on our balance sheet:

Cash and cash equivalents would have increased by the cash available for general corporate purposes, \$22.288 million plus the expenses deferred in other current assets of \$1.638 million.

Debt would have decreased as the proceeds would have been used to repay \$14.086 million under the term-loan portion of our senior secured loan agreement and our new revolving credit facility.

Stock compensation liability of \$12.034 million associated with the Variable Plan would be converted to stockholders' equity with the expected transfer of shares of common stock from Tom Sullivan to Kevin Sullivan. In addition, with the transfer of shares of common stock from Tom Sullivan to Kevin Sullivan, we will realize a current period tax deduction. This will result in a reduction of the related deferred tax asset of \$4.651 million and an offsetting decrease in current taxes payable of \$1.326 million and an increase in other current assets (income taxes receivable) of \$3.325 million.

The increase in stockholders' equity of \$83.784 million would have been attributable to \$36.4 million in proceeds, the conversion of \$34.834 million of 7,952,018 shares of series A convertible preferred stock into 7,952,018 shares of common stock, and a \$1.221 million, \$0.751 million net of tax, acceleration of certain stock option agreements and the triggering event for the Regional Manager Stock Unit Plan.

**Table of Contents****Lumber Liquidators, Inc.****Unaudited Pro Forma Statements of Income**

(in thousands)

	Year Ended December 31, 2006			Nine Months Ended September 30, 2007		
	Actual	Adjustments(1)	Pro Forma	Actual	Adjustments(1)	Pro Forma
Net sales	\$ 332,060	\$	\$ 332,060	\$ 299,797	\$	\$ 299,797
Cost of sales	221,931		221,931	200,404		200,404
Gross profit	110,129		110,129	99,393		99,393
Selling, general and administrative expenses	88,716	(1,040)(b)		85,491		
		996(c)			(2,903)(b)	
		129(c)			97(c)	
		202(d)			152(d)	
		188(e)	89,191		141(e)	82,978
Operating income	21,413	(475)	20,938	13,902	2,513	16,415
Interest expense	722	(627)(a)		607	(479)(a)	
		(51)(g)	44		(39)(g)	89
Other (income) expense	(368)		(368)	(168)		(168)
Income before income taxes	21,059	203	21,262	13,463	3,031	16,494
Provision for income taxes	8,161	79(f)	8,240	5,185	1,167(f)	6,352
Net income	\$ 12,898	\$ 124	\$ 13,022	\$ 8,278	\$ 1,864	\$ 10,142
Net income per common share(2):						
Basic	\$ 0.86		\$ 0.55	\$ 0.55		\$ 0.42
Diluted	\$ 0.56		\$ 0.54	\$ 0.36		\$ 0.42
Weighted average common shares outstanding:						
Basic	15,000,100	8,857,070	23,857,170	15,000,100	8,970,444	23,970,544
Diluted	22,989,403	916,327	23,905,730	23,096,460	1,049,432	24,145,892

See accompanying notes to unaudited pro forma statements of income

**Table of Contents**

**Notes to Unaudited Pro Forma Statements of Income**

- (1) Reflects the following adjustments:
- (a) Elimination of \$0.627 million and \$0.479 million for the year ended December 31, 2006 and nine months ended September 30, 2007, respectively for the interest expense associated with the borrowings under both the term-loan portion of our senior secured loan agreement and the revolving credit facility.
  - (b) Elimination of the stock compensation expense of \$1.040 million for the year ended December 31, 2006 and \$2.903 million for the nine months ended September 30, 2007 associated with the Variable Plan, which includes a guarantee by us.
  - (c) Increased stock compensation expense of \$0.996 million for the year ended December 31, 2006 related to the acceleration of certain stock option agreements. Increased stock compensation expense of \$0.129 million for the year ended December 31, 2006 and \$0.097 million for the nine months ended September 30, 2007 for the triggering event for the Regional Manager Stock Unit Plan.
  - (d) Increased stock compensation expense of \$0.202 million for the year ended December 31, 2006 and \$0.152 million for the nine months ended September 30, 2007 related to restricted stock grants of approximately 90,200 shares of common stock that we intend to grant to certain employees, whose salaries, commissions and benefits are recorded within selling, general and administrative expenses, and service providers at the closing of the initial public offering.
  - (e) Increased stock compensation expense of \$0.188 million for the year ended December 31, 2006 and \$0.141 million for the nine months ended September 30, 2007 related to stock option grants that we intend to grant certain executive officers and employees whose salaries, commissions and benefits are recorded within selling, general and administrative expenses, and service providers on the day this offering is priced for sale to the public to purchase approximately 125,000 shares of common stock at the initial public offering price.
  - (f) Application of the appropriate statutory tax rates of the respective tax jurisdictions to which adjustments relate, 38.8% in 2006 and 38.5% in the nine months ended September 30, 2007.
  - (g) Elimination of \$0.051 million for the year ended December 31, 2006 and \$0.039 million for the nine months ended September 30, 2007 associated with the accretion of redeemable preferred stock.
- (2) Pro forma basic and diluted net income per common share are computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period and include the effect of issuing additional shares of common stock at a price of \$11.00 per share in this offering used to repay amounts outstanding under the term-loan portion and the revolving facility portion of our senior unsecured loan agreement.

**Table of Contents**

The following table summarizes the pro forma effect to our earnings per share (EPS):

	<b>Year Ended December 31, 2006</b>	<b>Nine Months Ended September 30, 2007</b>
Pro forma weighted average common shares outstanding, including preferred stock conversion to common stock	22,952,118	22,952,118
Effect of shares issued(3)	905,052	1,018,426
Pro forma weighted average common shares outstanding including effect of shares issued	23,857,170	23,970,544
Dilutive effect of stock options	48,560	175,348
Pro forma weighted average common shares and dilutive securities outstanding	23,905,730	24,145,892

- (3) The effect of shares issued considers only those shares whose proceeds are being reflected in pro forma adjustments to the income statement rather than the full number of shares issued by us in this offering. The shares were determined as the quotient of our average debt balance over the period reflected in the pro forma income statement and the initial price per share shown on the cover page of this prospectus.

**Table of Contents****SELECTED FINANCIAL DATA**

You should read the data set forth below in conjunction with our financial statements and related notes and Management's Discussion and Analysis of Financial Condition and Results of Operations, Unaudited Pro Forma Financial Information and other financial information included elsewhere in this prospectus. We derived the selected financial data as of December 31, 2005 and 2006 and for each of the years ended December 31, 2004, 2005 and 2006 from our audited financial statements and the related notes appearing elsewhere in this prospectus. We derived the selected financial data as of December 31, 2004 from our audited financial statements and the related notes not included in this prospectus. We derived the selected financial data as of and for the years ended December 31, 2002 and 2003 from our unaudited financial statements not included in this prospectus. The selected statements of income data for the nine months ended September 30, 2006 and 2007 and the selected balance sheet data as of September 30, 2007 have been derived from our unaudited financial statements appearing elsewhere in this prospectus which, in the opinion of our management, have been prepared on the same basis as the audited financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of our operating results and financial position for those periods and as of those dates. The selected unaudited financial data for the nine months ended September 30, 2007 are not necessarily indicative of our results for the year ending December 31, 2007 and our historical results are not necessarily indicative of our results for any future period.

	Nine Months Ended							
	Year Ended December 31,					September 30,		
	2002	2003	2004	2005	2006(1)	2006(1)	2007(1)	
	(unaudited)	(unaudited)	(in thousands, except share and per share amounts)			(unaudited)	(unaudited)	
<b>Statement of Income Data</b>								
Net sales	\$ 65,382	\$ 100,866	\$ 171,766	\$ 244,947	\$ 332,060	\$ 247,219	\$ 299,797	
Cost of sales	43,051	67,870	115,857	158,844	221,931	163,955	200,404	
Gross profit	22,331	32,996	55,909	86,103	110,129	83,264	99,393	
Selling, general and administrative expenses	17,545	29,566	48,461	67,900	88,716	64,611	85,491	
Impairment loss on long-lived assets		955	293					
Operating income	4,786	2,475	7,155	18,203	21,413	18,653	13,902	
Interest expense	160	218	429	638	722	548	607	
Other (income) expense(2)	(318)	(428)	190	(96)	(368)	(303)	(168)	
Income before income taxes	4,944	2,685	6,536	17,661	21,059	18,408	13,463	
Provision for income taxes(3)	163	65	(1,450)	6,948	8,161	7,133	5,185	
Net income	\$ 4,781	\$ 2,620	\$ 7,986	\$ 10,713	\$ 12,898	\$ 11,275	\$ 8,278	
<b>Net income per common share:</b>								
Basic	\$ 0.32	\$ 0.17	\$ 0.53	\$ 0.71	\$ 0.86	\$ 0.75	\$ 0.55	
Diluted	\$ 0.32	\$ 0.17	\$ 0.51	\$ 0.46	\$ 0.56	\$ 0.49	\$ 0.36	
<b>Weighted average common shares outstanding(4):</b>								
Basic	15,000,100	15,000,100	15,000,100	15,000,100	15,000,100	15,000,100	15,000,100	

Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

Diluted	15,000,100	15,000,100	15,675,477	23,063,174	22,989,403	23,001,681	23,096,460
---------	------------	------------	------------	------------	------------	------------	------------

- (1) We adopted the provisions of SFAS 123 (R), using the prospective-transition method, effective January 1, 2006.  
(2) Includes interest income.

**Table of Contents**

- (3) Effective December 1, 2004, we elected to be taxed as a C corporation for federal and state income tax purposes. Prior to this election, we were not subject to federal and certain state income taxation at the corporation level.
- (4) Share amounts as of December 31, 2002 and 2003 have been adjusted to reflect the December 2004 common stock dividend of 150,000:1 to Tom Sullivan, our founder and chairman of our board of directors.

	As of December 31,					As of
	2002	2003	2004	2005	2006	September 30,
	(unaudited)	(unaudited)	(in thousands)			2007
						(unaudited)
<b>Balance Sheet Data</b>						
Cash and cash equivalents	\$ 384	\$ 3,073	\$ 3,031	\$ 6,031	\$ 3,965	\$ 5,666
Merchandise inventories	9,501	14,910	22,507	30,009	51,758	74,944
Total assets	13,249	21,017	39,753	55,162	78,020	106,395
Total debt and capital lease obligations, including current maturities	2,555	2,617	12,364	10,360	9,603	14,275
Stock compensation liability	850	2,020	4,958	8,092	9,132	12,034
Redeemable preferred stock			34,693	34,744	34,795	34,834
Total stockholder s equity (deficit)	4,260	3,620	(30,242)	(18,775)	(5,468)	4,108
Working capital(1)	4,299	5,230	8,091	17,059	29,697	24,686

- (1) Working capital is defined as current assets minus current liabilities.



**Table of Contents**

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

*You should read the following discussion together with Selected Financial Data and our financial statements and related notes included elsewhere in this prospectus. The discussion contains forward-looking statements involving risks, uncertainties and assumptions that could cause our results to differ materially from expectations. Factors that might cause these differences include those described under Risk Factors, Forward-Looking Statements and elsewhere in this prospectus.*

**Overview**

Lumber Liquidators is the largest specialty retailer of hardwood flooring in the United States, based on total sales. We offer an extensive selection of premium hardwood flooring products from more than 25 domestic and exotic wood species under multiple proprietary brands, together with a broad assortment of flooring enhancements and installation accessories, at everyday low prices that appeal to a diverse customer base. We purchase flooring directly from supplier mills and brokers, thereby avoiding mark-ups by distributors. As of September 30, 2007, we sold our products through 111 Lumber Liquidators stores in 42 states, a call center, our website and a catalog. Our low-cost store model utilizes a no frills showroom with limited in-store inventory. We currently finish approximately 70% of our premium Bellawood products at our Toano finishing line and distribution center to ensure product quality and to reduce third-party finishing costs. Approximately 85% of our merchandise passes through this facility before we move it to our stores. We believe that our vertically integrated business model enables us to offer a broad assortment of high-quality products to our customers at a lower cost than our competitors.

The growth in our net sales has been driven by new store openings and our strong comparable store sales performance. In the period from January 1, 2003 to September 30, 2007, we opened 86 stores, representing more than three-quarters of our total store base. Our gross profit is driven primarily by the cost of acquiring the products we sell from our suppliers, but also includes inbound transportation costs from those suppliers to our distribution center or stores, customs and duty charges, transportation charges from our distribution center to our stores and the cost of delivering product purchases to the customer. Our most significant operating expenses have historically been our advertising expenses and our labor costs. Our advertising costs have generally declined as a percentage of net sales as we have expanded, but may vary from quarter to quarter with shifts in marketing strategy and the timing of our marketing campaigns. Our labor costs have also declined as a percentage of net sales, while increasing in absolute terms as a result of our investment in the store support infrastructure, including enhancements to our management team. We expect that our aggregate operating expenses will decline as a percentage of our net sales as we implement our growth strategy and our business continues to grow.

In late 2005, we began a two-year program to implement various initiatives to improve our infrastructure and to position our business to support sustainable growth and profitability in the future. These initiatives included:

***Investing in our infrastructure.*** In response to the rapid growth in the number of new store locations that began in 2003, we slowed the pace of new store openings in 2006 to focus on expanding our store support infrastructure. As part of this process, we have assembled an experienced executive team to manage our day-to-day operations and reinforce the foundation that will enable us to achieve our long-term growth objectives. In September 2006, we hired our chief executive officer, and our founder transitioned to become the chairman of our board of directors, where he remains actively involved in developing and executing our marketing strategy, and enhancing the relationships with our supplier mills and brokers. During 2006 and 2007, we also hired a number of individuals with significant experience in the specialty retail industry, including a new chief information officer, a senior vice president of store operations, a

## **Table of Contents**

senior vice president of direct marketing and advertising, and a senior vice president of merchandising. We have also expanded our management structure by adding a senior vice president of supply chain and general corporate counsel. We have also restructured our regional operations by increasing the number of regional managers from eight to 15 to support future growth and assist in maintaining pricing and cost discipline.

***Expanding product assortment and improving our ability to meet customer requirements.*** We have expanded our product offerings to include a broader assortment of key product lines, including engineered hardwoods and solid hardwoods by Dura-Wood and hand-scraped hardwoods by Virginia Mill Works. We believe that presenting customers with a broader assortment of products with narrower price point differentials encourages customers to trade up to our premium products. We have also increased our emphasis on moldings and accessories, which enable us to make valuable add-on sales. In addition, we refined our merchandising strategy to optimize inventory levels through purchasing and logistics efforts to best match product availability with customers' varying delivery needs.

Although the hardwood flooring market is projected to experience long-term growth, estimated at a compound annual growth rate of 7.4% through 2011, Catalina Research estimates that U.S. hardwood flooring square-foot sales declined 10.6% in 2006 and declined 14.1% in the first half of 2007 compared to the same period in 2006. Similar declines were estimated across most types of flooring, and were due in particular to decreased new housing demand. Despite these market declines, however, our net sales increased 36% in 2006 and 20% in the first six months of 2007. See *Business Our Market*. Although the majority of our sales are to consumers engaged in remodeling projects, a decline in new housing demand could cause a decline in remodeling or remodeling activity could decline for other reasons. See *Risk Factors Risks Relating to Our Business and Industry*. The hardwood flooring industry depends on the economy, home remodeling activity, the homebuilding industry and other important factors. We believe that we will continue to benefit from several key long-term industry trends and characteristics, including increased home improvement spending resulting from aging housing stock, increasing home ownership, increasing average home size and favorable demographic trends as well as the expansion and evolution of the hardwood flooring market and the greater perceived attractiveness of hardwood flooring among consumers.

## **Assessing the Performance of Our Business**

In assessing the performance of our business, we consider a variety of performance and financial measures. The key measures we use to determine how our business is performing are net sales and comparable store sales. Some of the operational metrics that we consider in evaluating net sales include our sales mix, future demand as measured by open orders and the related customer deposits, the average number of days an order/customer deposit is outstanding, requests for samples and catalogs, new store performance levels and our new store pipeline. In assessing the overall performance of our business, we also consider gross profit and selling, general and administrative expenses.

### ***Net Sales***

We derive net sales primarily from sales of solid and engineered hardwoods, laminate, bamboo and cork flooring products, moldings and flooring accessories made through our stores, call center, website and catalog. Net sales, which include freight costs billed to customers, are net of any returns by customers. Net sales from customer orders placed through the call center, our website or our catalog are recorded by the store where the customer picks up the merchandise or schedules delivery. Several factors affect our net sales in any period, including the number of stores in operation and comparable store sales for any given store or group of stores, which can be influenced by our operational effectiveness, pricing, marketing and promotional efforts, brand recognition levels, local competition and trade area demographics.

## **Table of Contents**

**Growth In Our Store Base.** We opened 17 stores in 2004, 19 stores in 2005 and 16 stores in 2006, which contributed substantially to the growth of our net sales in those years. In 2006, we slowed the increase in new store locations as we expanded our store support infrastructure to better facilitate sustainable growth of both our net sales and gross margin. As of September 30, 2007, we had opened 20 new stores and had signed leases for seven additional stores. We plan to open at least 25 new stores in total during 2007 and between 30 and 40 new stores during each of the next several years thereafter. The cost required to open a typical new store is approximately \$240,000, of which inventory, net of trade payables, represents approximately \$190,000. Our new stores have historically opened with an initial ramp-up period typically lasting from 36 to 48 months or more, during which they generated sales below the levels at which we expect them to normalize. Our average new store across our markets has, however, historically become profitable within three months of beginning operations and returned its initial cash investment within seven months. See Risk Factors Risks Related to Our Business and Industry The planned rapid increase in the number of our stores may make our future results unpredictable.

**Comparable Store Sales.** The other important driver of growth in our net sales has been increased comparable store sales, which accounted for a substantial portion of our historical net sales growth. Stores enter the comparable store base on the first day of the thirteenth full calendar month after they open. Various factors affect comparable store sales, including:

consumer preferences, buying trends and overall economic trends and our ability to anticipate and respond effectively to changes therein;

changes in our overall merchandise sales mix and changes in our sales mix with respect to each of our sales channels;

pricing;

the timing of our promotional events;

competition;

our ability to source and distribute products efficiently;

the number of stores we open or close in any period; and

weather and other climatological effects.

We believe that future comparable store sales will likely increase at rates slower than those achieved over the past several years, due to increases in baseline store volumes and an increase in the number of new stores opened in existing markets, which tend to open at a higher base level of sales. See Risk Factors Risks Related to Our Business and Industry Failure to manage our growth effectively could harm our business and operating results.

## ***Gross Profit and Gross Margin***

Gross profit is equal to our net sales minus our cost of sales, and gross margin is equal to gross profit as a percentage of net sales. Our gross profit has historically been affected by, among other things:

## Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

our sales volumes and the margins on products we sell;

the mix of our products sold and the related cost of that merchandise, including in particular the cost of hardwood and other flooring products and accessories;

transportation costs, both from our suppliers to our distribution center or stores and from our distribution center to our stores, which may vary with factors such as fuel costs;

customs and duty charges on international purchases;

the cost of third-party carrier services providing customer deliveries;

**Table of Contents**

in-house finishing costs, particularly for our Bellawood brand;

the costs of providing samples requested by our customers;

inventory adjustments, including shrinkage;

the extent of any mark-downs and the volume of inventory impacted by sales and promotional events; and

competition.

We try to minimize the volatility of hardwood prices which represents the largest portion of our cost of sales by relying on our close relationships with our suppliers and utilizing our financial flexibility to establish beneficial payment terms. Generally, we strive to match merchandise purchase lead times with anticipated demand to maximize sustainable gross margins, and those lead times currently range by product from approximately 90 to 180 days.

We work to improve gross profits and gross margin on an ongoing basis through inventory management improvements, logistics alternatives, pricing levels, promotional activities and vendor relationships, among other things. Several of our recent initiatives to position our business for more effective future growth have also had a significant impact on our gross margins, and we continue to assess various opportunities. We continually review our inventory levels and sales mix on a regular basis to identify slow-moving merchandise and products which do not meet our quality standards and cannot be sold at full price, and generally use promotional events and mark-downs to clear that inventory. We believe that, taken together, the changes we have made and intend to implement should enable us to sustain and gradually increase our gross margins in future periods. Our gross profits and gross margins may not be comparable to other companies that record different costs as components of cost of sales.

***Selling, General, Administrative and Other Operating Expenses***

***Advertising Expenses.*** The largest component of our selling, general and administrative ( SG&A ) expenses is advertising expenses at the national, regional and local level, as well as costs associated with publishing our catalogs and maintaining our website. We have made a significant investment in advertising to develop our national brands, including our portfolio of proprietary product offerings. We believe Lumber Liquidators is now recognized across the United States as a destination for high-quality hardwood flooring at everyday low prices. We have historically focused on national advertising, including buying ads in national publications, using targeted television advertising, co-sponsoring television shows, advertising on syndicated radio programs and sports marketing. In the future, we expect to place greater focus on local advertising to support targeted store growth and in connection with new store openings while maintaining appropriate levels of national advertising. As we open more stores we expect to see greater returns on our investment in national advertising as more stores open near potential customers who have already been introduced to our brands. In addition, while our advertising costs may vary from quarter to quarter with shifts in marketing strategy and the timing of our marketing campaigns, we believe that the percentage of our net sales devoted to marketing and advertising will generally decline as we continue to grow. See Risk Factors Risks Relating to Our Business and Industry Our success depends on the continued effectiveness of our advertising strategy.

***Labor Costs.*** The second-largest component of our SG&A expenses is expenses relating to employees, consisting principally of salaries, commissions and benefits paid to employees in our stores which increase as we open more stores and employees in our distribution facility and headquarters which should increase more slowly as we grow. Most of our labor costs relate to staff at our stores and our distribution facility. However, labor costs have recently increased significantly as we improved our store support strategies and operational infrastructure, positioning our business for more effective and sustainable future growth. We believe that the percentage of our net sales devoted to labor costs will generally decline as we continue to grow.

---

## **Table of Contents**

**Other Expenses.** Our SG&A expenses also include occupancy costs for our stores, warehouse and headquarters (including rent, utilities, real estate taxes and maintenance charges); equity compensation expenses (including expenses relating to the Variable Plan); and other expenses such as credit and debit card discount and processing fees, costs relating to our delivery fleet (including payroll and maintenance), depreciation and amortization, bank fees, legal and professional fees and other corporate and administrative functions that support our stores. SG&A expenses also include store opening costs, which we expense as they are incurred. In 2004, our operating expenses also included an impairment loss on long-lived assets relating to the relocation of our finishing line and corporate headquarters to Toano.

### **Other Factors Affecting Our Results**

#### ***Equity Compensation Expenses***

We maintain four equity compensation plans: a newly adopted equity compensation plan for employees, non-employee directors and other service providers (the 2007 Plan ); a stock option plan for executive management; a stock option plan for non-employee members of our board of directors; and a stock unit plan for regional store management. The 2007 Plan was adopted in August 2007, and we have not issued any stock options or stock-based awards under that plan. No further awards will be granted under the prior stock option plans following this offering. We have not recorded any compensation expense relating to the stock unit plan because those units would have expired without value unless an IPO or sale event occurs before 2011. In addition, we intend to make restricted stock grants to certain employees and service providers and stock option grants to certain executive officers, employees and service providers at the closing of the initial public offering. In connection with this offering, we expect to incur a charge of approximately \$1.2 million in the quarter of 2007 in which this transaction closes relating to the stock unit plan and acceleration of options under the 2004 and 2006 stock option plans.

We are also party to the Variable Plan, an agreement between Tom Sullivan and Kevin Sullivan, Tom's brother, who started our western U.S. operations and was our first regional manager, pursuant to which we generally guarantee Tom's cash payment obligation under the agreement. We account for that agreement as a variable performance plan. Under the Variable Plan, as amended in August 2005, Kevin has the right to a fixed ownership percentage of Lumber Liquidators, Inc. on a fully diluted basis, plus an additional ownership percentage based on certain performance criteria. This right is exercisable for shares of common stock, to be contributed by Tom and which have been placed in escrow, in conjunction with an IPO or sales event. Kevin's right under the plan will be considered to be exercised in full immediately prior to the completion of the initial public offering and, accordingly, we do not expect to record any future charges relating to the Variable Plan other than an adjustment in the quarter in which this transaction closes to reflect the difference between the estimated value of the common stock as of September 30, 2007 and the final closing price for the number of shares considered earned by Kevin. Before the Variable Plan was amended in August 2005, we recorded stock-based compensation expense based on Kevin having earned a 5% ownership interest on a fully diluted basis (in conformity with the terms of that agreement). We recorded stock-based compensation expense relating to the Variable Plan of \$2.9 million in the first nine months of 2007, \$1.0 million in 2006, \$3.1 million in 2005 and \$2.9 million in 2004, and carried a short-term liability on our balance sheet relating to the agreement of \$12.0 million at September 30, 2007. See Risk Factors Risks Relating to Our Business and Industry We will incur non-cash compensation expenses, and may be required to issue shares of common stock, in connection with existing stock-based compensation agreements. A \$1 change, up or down, between the estimated value of the common stock as of September 30, 2007 and the price of stock on the trading day before the closing of this offering would change the non-cash compensation expense associated with the Variable Plan by \$0.9 million.

In addition, we had an employment agreement and a stock warrant plan with a former senior executive (who resigned on May 31, 2006). The former executive has filed a demand for arbitration alleging that he terminated his employment for good reason, as defined in his employment agreement and the warrant plan. In his demand for arbitration, the former senior executive contends that we

**Table of Contents**

breached our obligations to him upon his resignation of employment. He is seeking damages of approximately \$0.7 million (plus the value of certain other specified benefits), as well as a declaration that he has owned 1% of the company since he terminated his employment. An arbitration hearing was held on October 1-2, 2007. The parties will be afforded the opportunity to submit post-arbitration briefs and additional testimony and evidence may be presented. Stock-based compensation expenses under this plan for 2005 and 2004 were reversed in 2006 upon separation, with an offset to additional capital. See Business Legal Proceedings.

For additional information regarding our equity compensation plans, see Management Executive Compensation and Note 7 to our audited financial statements and Note 4 to our unaudited condensed financial statements.

**Income Taxes**

Effective December 1, 2004, we elected to be taxed as a C corporation for federal and state income tax purposes, and we have provided for income taxes since that date. The effect of initially recognizing deferred tax assets and liabilities related to this change in tax status was included in the provision for income taxes for 2004. We were not subject to federal and certain state income taxation at the corporation level prior to that election. Our effective tax rate will vary based on state-tax allocations and future tax minimization strategies in future periods.

**Results of Operations**

The following tables set forth components of our results of operations for the periods indicated, both in dollars and as a percentage of net sales.

	Year Ended December 31,			Nine Months Ended		Three Months Ended	
	2004	2005	2006	September 30,		September 30,	
	2004	2005	2006	2006	2007	2006	2007
	(in millions, except percentages and numbers of stores)						
Net sales	\$ 171.8	\$ 244.9	\$ 332.1	\$ 247.2	\$ 299.8	\$ 83.1	\$ 102.1
Comparable store sales increase from prior year	38.2%	19.0%	17.3%	19.2%	8.6%	12.8%	8.4%
Number of stores opened in period(1)	17	19	16	9	20	1	8
Cost of sales	115.9	158.8	221.9	164.0	200.4	55.7	67.6
Gross profit	55.9	86.1	110.1	83.3	99.4	27.4	34.4
SG&A expenses	48.5	67.9	88.7	64.6	85.5	22.6	28.3
Operating income	7.2	18.2	21.4	18.7	13.9	4.8	6.2
Net income(2)	8.0	10.7	12.9	11.3	8.3	2.9	3.7

	Year Ended December 31,			Nine Months Ended		Three Months Ended	
	2004	2005	2006	September 30,		September 30,	
	2004	2005	2006	2006	2007	2006	2007
	(% of net sales)						
Net sales	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Cost of sales	67.5%	64.8%	66.8%	66.3%	66.8%	67.0%	66.2%
Gross profit	32.5%	35.2%	33.2%	33.7%	33.2%	33.0%	33.8%
SG&A expenses	28.2%	27.7%	26.7%	26.1%	28.5%	27.2%	27.7%
Operating income	4.2%	7.4%	6.4%	7.5%	4.6%	5.8%	6.1%
Net income(2)	4.6%	4.4%	3.9%	4.6%	2.8%	3.5%	3.6%

- (1) In May 2006, we closed a laminate flooring-only store that had been established to operate during the remaining lease period of a relocated store.
- (2) Effective December 1, 2004, we elected to be taxed as a C corporation for federal and state income tax purposes. Prior to this election, we were not subject to federal and certain state income taxation at the corporation level.





---

**Table of Contents**

**Three Months Ended September 30, 2007 Compared to Three Months September 30, 2006**

**Net Sales.** Net sales increased approximately \$19.0 million, or 23%, to \$102.0 million for the three months ended September 30, 2007 from \$83.1 million for the three months ended September 30, 2006. This increase was primarily driven by an increase of \$11.9 million in non-comparable store sales, including \$6.0 million at the 20 stores opened in 2007, and by an increase of \$7.1 million, or 8.4%, in comparable store sales. Increases in comparable store sales were driven primarily by the continued maturation of stores in operation for 13 to 36 months, where net sales increased \$5.3 million, or 25%, and by generally strong consumer demand for our expanded product assortment, including new lines of hand-scraped solid and engineered hardwoods, more durable laminates and strand bamboo, introduced late in the second quarter of 2007. Net sales benefited from an increase in sales volume, primarily measured in square footage, and an increase in the average retail price per unit sold. In addition, moldings and accessories, generally add-on purchases, increased \$2.6 million, or 36%, and represented 10% of total sales in the three months ended September 30, 2007.

**Gross Profit and Gross Margin.** Gross profit increased approximately \$7.0 million, or 26%, to \$34.4 million for the three months ended September 30, 2007 from \$27.4 million for the three months ended September 30, 2006, principally due to increases in net sales partially offset by a net higher cost from suppliers for the merchandise sold and an overall increase in transportation costs. Gross margin for the three months ended September 30, 2007 increased approximately 80 basis points to 33.8% from 33.0% for the three months ended September 30, 2006. This increase was primarily a result of the sales strength of new product lines introduced late in the second quarter of 2007, including new lines of hand-scraped solid and engineered hardwoods, more durable laminates and strand bamboo. These products typically carry a higher average retail price per unit and a higher gross margin than our average product, and are a part of the initiative we began in 2006 to broaden our assortment and the price points available to our customers. Logistics initiatives implemented in the three month period ended September 30, 2007 benefited gross margin through reductions in both the number of miles driven by trucks supplying our products and the per-mile cost of transporting our products. This benefit was partially offset by greater per unit international transportation costs, including the implementation or increase of a number of key tariffs assessed on imported products, most notably bamboo and certain products from Brazil.

**Operating Income.** Operating income for the three months ended September 30, 2007 increased \$1.4 million, or 29%, to \$6.2 million, as the \$7.0 million increase in gross profit was partially offset by a \$5.7 increase in SG&A expenses, principally due to the following factors:

Salaries, commissions and benefits increased \$2.7 million, or 37%, primarily due to the increase in the number of new store locations and the significant investment in executive and operational management within our store support infrastructure. The investment in executive and operational store support management during 2006 included our new chief executive officer in September 2006 and the addition of six regional managers and two senior executive positions that did not exist at September 30, 2006. In addition, we added more finance, compliance and information technology control personnel in 2007 as we prepared to become a public company. Accordingly, as a percentage of net sales, salaries, commissions and benefits increased to 10.0% for the three months ended September 30, 2007 from 9.0% for the same period in 2006.

Advertising expenses increased \$1.3 million, or 14%, primarily due to the expansion of both our national advertising branding campaign through television, radio and sports marketing, and our direct mail programs. As a percentage of net sales, however, advertising expenses decreased to 10.2% for the three months ended September 30, 2007 from 11.0% for the same period in 2006 as we were able to leverage the expansion of our national advertising campaign over increased sales.

Occupancy costs increased \$0.8 million, or 30%, and also increased to 3.3% from 3.1% as a percentage of net sales, as the increase in costs related to new stores openings, including 18

---

**Table of Contents**

opened in the second and third quarter, were only partially offset by increases in net sales. Six new stores were opened in the second and third quarters of 2006.

Depreciation and amortization increased \$0.2 million, but remained a constant 0.9% as a percentage of net sales.

Stock-based compensation expense decreased \$0.2 million. A reduction in the compensation associated with the Variable Plan was partially offset by increased stock-based compensation expense related to stock options granted after September 30, 2006.

Certain other expenses, including legal and professional fees, increased approximately \$0.8 million, primarily as we prepared to become a public company. Further, certain banking fees, including bankcard discounts, increased commensurate with sales.

As a percentage of net sales, operating income increased to 6.1% for the three months ended September 30, 2007 from 5.8% for the three months ended September 30, 2006. This increase was primarily due to the increase in gross margin to 33.8% and SG&A expenses to 27.7% for the three months ended September 30, 2007 from 33.0% and 27.2%, respectively, for the three months ended September 30, 2006.

**Net Income.** Net income increased approximately \$0.8 million to \$3.7 million for the three months ended September 30, 2007 from \$2.9 million for the three months ended September 30, 2006 and increased as a percentage of net sales to 3.6% for the three months ended September 30, 2007 from 3.5% for the three months ended September 30, 2006. Our effective income tax rate was approximately 38.3% for the three months ended September 30, 2007 and 38.7% for the three months ended September 30, 2006, reflecting slight variances in state income tax rates.

**Nine Months Ended September 30, 2007 Compared to Nine Months Ended September 30, 2006**

**Net Sales.** Net sales increased approximately \$52.6 million, or 21%, to \$299.8 million for the nine months ended September 30, 2007 from \$247.2 million for the nine months ended September 30, 2006. This increase was primarily driven by an increase of \$31.3 million in non-comparable store sales, including \$8.6 million at the 20 stores opened in 2007, and an increase of \$21.3 million, or 8.6%, in comparable store sales. Increases in comparable store sales were driven primarily by the continued maturation of stores in operation for 13 to 36 months, where net sales increased \$14.9 million, or 26.1%, and generally strong consumer demand for our expanded product assortment. Net sales benefited from an increase in sales volume, primarily measured in square footage, and an increase in the average retail price per unit sold. Increased demand was driven in part by strength in the sales of the Bellwood line, particularly exotic hardwoods, and the broader assortment of engineered hardwoods, including an expanded offering of hand-scraped products, which offset declines in sales of liquidation deals and unfinished hardwoods. Further, for the nine month period ended September 30, 2007, moldings and accessories increased \$8.9 million, or 46%, and represented 10% of total sales in the nine months ended September 30, 2007, up from 8% of total sales for the same period in 2006.

**Gross Profit and Gross Margin.** Gross profit increased approximately \$16.1 million, or 19%, to \$99.4 million for the nine months ended September 30, 2007 from \$83.3 million in first nine months of 2006, principally due to increases in net sales partially offset by a net higher cost from suppliers for the merchandise sold and an increase in transportation costs. Gross margin for the nine months ended September 30, 2007 decreased approximately 50 basis points to 33.2% from 33.7% for the nine months ended September 30, 2006. This decrease resulted principally from our efforts to broaden our product assortment and the range of retail price points available to our customers, an initiative we began in the first quarter of 2006. We initially introduced prefinished engineered hardwood lines, which drove

## Table of Contents

increases in net sales and gross profit, but those products typically carry a margin lower than our average product. Late in the second quarter of 2007, we introduced new hand-scraped solid and engineered hardwoods, more durable laminates and strand bamboo lines that have a higher than average gross margin. Increases in domestic and international transportation costs also caused gross margin to decline, as per-mile ground charges increased primarily due to higher fuel costs, and the implementation or increase in 2007 of a number of key tariffs assessed on imported products, most notably bamboo. These increases were partially offset by decreases in our transportation costs resulting from logistic initiatives, implemented in the third quarter of 2007, that are designed to reduce both the miles driven by trucks supplying our stores and the per mile cost of shipping our products.

**Operating Income.** Operating income for the nine months ended September 30, 2007 decreased \$4.8 million, or 26%, to \$13.9 million, as a \$20.9 million increase in SG&A expenses was partially offset by a \$16.1 million increase in gross profit, principally due to the following factors:

Salaries, commissions and benefits increased \$7.8 million, or 37%, primarily due to the increase in the number of new store locations and the significant investment in executive and operational management within our store support infrastructure. The investment in executive and operational store support management during 2006 included our new chief executive officer, four senior executive positions supporting the stores and six regional store managers. In addition, we added more finance, compliance and information technology control personnel in 2007 as we prepared to become a public company. Accordingly, as a percentage of net sales, salaries, commissions and benefits increased to 9.7% for the nine months ended September 30, 2007 from 8.6% for the nine months ended September 30, 2006.

Advertising expenses increased \$4.9 million, or 18%, for the nine months ended September 30, 2007, primarily due to the expansion of our national advertising branding campaign through television, radio and sports marketing, coupled with local advertising and direct mail programs. As a percentage of net sales, however, advertising expenses decreased to 10.6% for the nine months ended September 30, 2007 from 10.9% for the comparable period in 2006, as we were able to leverage that expansion over larger increases in net sales.

Stock-based compensation expense increased \$3.4 million to \$4.2 million for the nine months ended September 30, 2007 from \$0.8 million in the first nine months of 2006, primarily due to an increase of \$2.1 million in the stock compensation calculated under the Variable Plan and \$1.0 million in stock compensation expense related to stock options granted in July and October 2006 and April 2007.

Occupancy costs increased \$1.6 million, but remained a consistent 3.0% as a percentage of net sales, as costs related to the opening of 26 store locations since September 30, 2006 were offset by increases in net sales.

Depreciation and amortization increased \$0.5 million but remained a constant 0.9% as a percentage of net sales.

Certain other expenses, including legal and professional fees, increased \$2.7 million as we enhanced our financial reporting, legal and regulatory compliance, internal controls and corporate governance. Further, certain banking fees, including bankcard discounts, increased commensurate with sales.

As a percentage of net sales, operating income declined to 4.6% for the nine months ended September 30, 2007 from 7.5% for the nine months ended September 30, 2006. This decrease was primarily due to the decline in gross margin and an increase in SG&A expenses as a percentage of net sales to 28.5% for the nine months ended September 30, 2007 from 26.1% for the nine months ended September 30, 2006.

## Table of Contents

**Net Income.** Net income decreased approximately \$3.0 million to \$8.3 million for the nine months ended September 30, 2007 from \$11.3 million for the nine months ended September 30, 2006 and declined as a percentage of net sales to 2.8% for the nine months ended September 30, 2007 from 4.6% for the nine months ended September 30, 2006. Our effective income tax rate was approximately 38.5% for the nine months ended September 30, 2007 and 38.7% for the nine months ended September 30, 2006, reflecting slight variances in state income tax rates.

### **Year Ended December 31, 2006 Compared to Year Ended December 31, 2005**

**Net Sales.** Net sales increased \$87.1 million, or 36%, to \$332.1 million in 2006 from \$244.9 million in 2005. This increase was primarily driven by an increase of \$42.0 million, or 17.3%, in comparable store sales, and by a \$28.7 million increase in non-comparable net sales at the 19 stores opened during 2005, and \$16.4 million at the 16 new stores opened during 2006. Comparable store sales increases were driven principally by maturation of new stores, optimization of our product mix to reflect customer demand and increased traffic across our store base. The average retail price per unit sold also increased slightly. Overall net sales increased due principally to the following factors:

In early 2006, we introduced a number of new prefinished engineered hardwood products over a range of retail price points not previously available, which increased sales in those product categories. We also continued to increase the percentage of our net sales represented by moldings and accessories, from 7% in 2005 to 8% in 2006.

Increases in comparable store sales and non-comparable net sales also resulted from the continuing maturation of our store base, as net sales at stores open for less than 36 months (56% of our stores in operation as of December 31, 2006) increased faster than our more mature stores.

Net sales also increased due to improvements we made to our website that, among other things, made it easier to place orders over the Internet.

**Gross Profit and Gross Margin.** Gross profit increased \$24.0 million, or 28%, to \$110.1 million in 2006 from \$86.1 million in 2005, principally as a result of increases in net sales that were partially offset by higher average supplier costs and an increase in transportation costs. Gross margin decreased approximately 200 basis points to 33.2% in 2006 from 35.2% in 2005, which was principally due to the following factors:

The implementation of our 2006 initiative to broaden our product range increased net sales but caused our gross margin to decline. In particular, we expanded our sales mix to include some products, such as engineered hardwoods, that have a lower gross margin than our average product, which caused an approximately 120 basis point decline in gross margin. The introduction of additional products in our Dura-Wood line also caused an approximately 30 basis point decline in gross margin, as those products have a lower gross margin than our average product and because we implemented a retail pricing strategy designed to enable those products to gain market share.

As part of our efforts to optimize inventory levels, we implemented a number of price discounts (primarily during the fourth quarter of 2006) with respect to slower-moving inventory. We also were required to increase reserves for product warranties due to a purchase of defective merchandise from one supplier. These actions collectively resulted in an approximately 30 basis point decline in our gross margin.

Decreases in the prices of certain product categories, particularly laminates and bamboo, designed to increase net sales and optimize our product mix, which were further impacted by supplier unit cost increases that were not passed on proportionately to our customers, resulted in an approximately 25 basis point decline in gross margin.



## Table of Contents

Higher domestic and international transportation costs, primarily due to higher fuel and ocean freight costs, customs duties and per-mile ground charges, also caused a decline in gross margin.

These decreases were partially offset by increases in gross margin that resulted from increased efficiencies at our Toano finishing line, slightly higher sales volumes of moldings and accessories (as those products generally have a higher gross margin than that our average product) and savings from new, longer-term international transportation contracts.

**Operating Income.** Operating income increased \$3.2 million, or 18%, to \$21.4 million in 2006, principally as a result of the \$24.0 million increase in gross profit that was partially offset by a \$20.8 million increase in SG&A expenses principally due to the following factors:

Advertising expenses increased \$8.7 million, or 32%, in 2006 primarily due to the expansion of our national advertising campaign through television, radio and sports, as well as increased costs relating to online advertising and direct mail programs. As a percentage of net sales, advertising expenses declined to 10.9% in 2006 from 11.3% in 2005, principally due to our ability to leverage our national advertising over increased net sales across all our sales channels.

Salaries, commissions and benefits increased \$6.1 million, or 26%, in 2006 primarily due to an increase in the store support infrastructure principally in the second half of 2006, including the hiring of our new chief executive officer and other executives and operational managers. As a percentage of net sales, salaries, commissions and benefits paid to our employees declined to 8.9% in 2006 from 9.6% in 2005, principally due to our ability to leverage our store support infrastructure over increased net sales, although several of the additional costs were not recognized over the full year.

Occupancy costs increased \$2.3 million, or 28%, in 2006 principally due to 16 new stores opened in 2006 and the full-year impact of 19 stores opened in 2005. As a percentage of net sales, occupancy costs decreased to 3.1% in 2006 from 3.3% in 2005.

Professional expenses increased \$0.8 million to support enhanced financial reporting, legal and regulatory compliance, internal controls and corporate governance functions.

Stock-based compensation expense decreased due to lower current-year expense associated with the Variable Plan, which was partially offset by expense related to stock options granted in 2006.

As a percentage of net sales, operating income declined to 6.4% in 2006 from 7.4% in 2005. This decrease was primarily due to the decline in gross margin, partially offset by a decline in SG&A expenses as a percentage of net sales to 26.7% in 2006 from 27.7% in 2005.

**Net Income.** Net income increased \$2.2 million to \$12.9 million in 2006 from \$10.7 million in 2005, but declined as a percentage of net sales to 3.9% in 2006 from 4.4% in 2005. Our effective income tax rate was approximately 38.8% for 2006 compared to 39.3% for 2005, reflecting slight variances in state income tax rates.

## **Year Ended December 31, 2005 Compared to Year Ended December 31, 2004**

**Net Sales.** Net sales increased \$73.2 million, or 43%, to \$244.9 million in 2005 from \$171.8 million in 2004. This increase was primarily driven by an increase of \$32.6 million, or 19.0%, in comparable store sales, and also by additional non-comparable store sales of \$18.3 million at the 17 stores opened during 2004 and \$22.2 million at the 19 new stores opened during 2005. Comparable store sales increases were driven principally by maturation of new stores, expansion of our product mix

## Table of Contents

and increased traffic across our store base. The average retail price per unit sold also increased slightly. Overall net sales increased due principally to the following factors:

In 2005, we introduced several new product lines of prefinished hardwoods by Dura-Wood, which we believe customers choose more often in lieu of unfinished hardwoods that carry a lower average unit retail price. In addition, we increased our emphasis on selling add-on moldings and accessories, and the percentage of our net sales represented by those products increased from 5% in 2004 to 7% in 2005.

Increases in comparable store sales and non-comparable net sales also resulted from the continuing maturation of our store base, as net sales at stores open for less than 36 months (67% of our stores in operation as of December 31, 2005) increase faster than our more mature stores.

**Gross Profit and Gross Margin.** Gross profit increased \$30.2 million, or 54%, to \$86.1 million in 2005 from \$55.9 million in 2004, principally as a result of increases in net sales primarily due to higher sales volumes, the mix of sales and lower average supplier costs. Gross margin increased approximately 260 basis points to 35.2% in 2005 from 32.5% in 2004, which was principally due to the following factors:

As part of our effort to optimize our sales mix, we increased sales of add-on moldings and accessories (products that generally have a higher gross margin than that our average product) to 7% in 2005 from lower levels in 2004, which resulted in an approximately 110 basis point increase in our gross margin.

We relocated our distribution and Bellawood finishing facility, and our headquarters, to Toano, which enabled us to significantly lower finishing costs. The new finishing line also enabled us to take advantage of our increased finishing capacity by allowing us to purchase larger volumes of merchandise, which we believe generally enabled us to lower vendor costs. Taken together, the relocation resulted in an approximately 85 basis point increase in our gross margin.

By increasing our product range, for example through the introduction of additional products in our Dura-Wood line, we were able to shift customers into choosing our premium prefinished products in lieu of lower margin alternatives such as unfinished products, which resulted in an approximately 50 basis point increase in our gross margin.

Lower domestic and international transportation costs, resulting primarily from lower fuel costs, also caused an increase in gross margin.

**Operating Income.** Operating income increased \$11.0 million, or 154%, to \$18.2 million in 2005, principally as a result of the \$30.2 million increase in gross profit that was partially offset by a \$19.4 million increase in SG&A expenses principally due to the following factors:

Advertising expenses increased \$7.5 million, or 37%, in 2005 primarily due to the expansion of the national advertising branding campaign through television, radio and sports. As a percentage of net sales, advertising expenses declined to 11.3% in 2005 from 11.7% in 2004, principally due to our ability to leverage our national advertising over increased net sales.

Salaries, commissions and benefits increased \$5.8 million, or 33%, in 2005 primarily due to the increase in the number of stores. As a percentage of net sales, salaries, commissions and benefits paid to our employees declined to 9.6% in 2005 from 10.2% in 2004, principally due to our ability to leverage our store support infrastructure over increased net sales.

Occupancy costs increased \$2.8 million, or 54%, in 2005 principally due to 19 new stores opened in 2005, the full-year impact of 17 stores opened in 2004 and the opening of our new Toano facility in 2005. As a percentage of net sales, occupancy costs increased to 3.3% in 2005 from 3.0% in 2004.



**Table of Contents**

Stock-based compensation expense increased to \$3.3 million, or 1.3% of net sales in 2005, from \$3.0 million, or 1.8% of net sales in 2004, primarily due to the amendment of the Variable Plan.

As a percentage of net sales, operating income increased to 7.4% in 2005 from 4.2% in 2004. This increase was primarily due to the increase in gross margin for the reasons described above and a decline in SG&A expenses as a percentage of net sales to 27.7% in 2005 from 28.2% in 2004.

**Net Income.** Net income increased \$2.7 million to \$10.7 million in 2005 from \$8.0 million in 2004, but declined as a percentage of net sales to 4.4% in 2005 from 4.6% in 2004, although pre-tax income increased to 7.2% of net sales in 2005 from 3.8% in 2004. Our effective income tax rate for 2005 was approximately 39.3%. Effective December 1, 2004, we elected to be taxed as a C corporation for federal and state income tax purposes. The effect of initially recognizing deferred tax assets and liabilities related to this change in tax status was included in the provision for income taxes for 2004. We were not subject to federal and certain state income taxes at the corporation level prior to that election.

**Quarterly Results and Seasonality**

The following table sets forth our unaudited quarterly results of operations for 2005, 2006 and the first, second and third quarters of 2007, and quarterly results as a percentage of our annual results for 2005 and 2006. The information for each of these periods has been prepared on the same basis as the audited financial statements included elsewhere in this prospectus. This information includes all adjustments, which consist only of normal and recurring adjustments, management considers necessary for the fair presentation of such data. This data should be read in conjunction with the audited financial statements included elsewhere in this prospectus. The results of operations for historical periods are not necessarily indicative of results for any future period.

	2007												
	2005 Quarter Ended (unaudited)				2006 Quarter Ended (unaudited)(1)(2)				Quarter Ended (unaudited)(1)(2)				
	Mar. 31,	June 30,	Sept. 30,	Dec. 31,	Mar. 31,	June 30,	Sept. 30,	Dec. 31,	Mar. 31,	June 30	Sept. 30	Dec. 31	
	(in millions)				(in millions)				(in millions)				
Net sales	\$ 50.8	\$ 61.6	\$ 63.2	\$ 69.3	\$ 244.9	\$ 76.1	\$ 88.1	\$ 83.1	\$ 84.8	\$ 332.1	\$ 92.0	\$ 105.7	\$ 102.1
Gross profit	18.0	21.2	22.4	24.5	86.1	26.4	29.5	27.4	26.8	110.1	30.6	34.4	34.4
Operating income	3.5	5.5	5.7	3.5	18.2	5.9	8.0	4.8	2.7	21.4	3.8	4.0	6.2
Net income	2.1	3.2	3.3	2.1	10.7	3.6	4.8	2.9	1.6	12.9	2.3	2.3	3.7

(1) Reflects expense relating to the Variable Plan in 2006 and 2007 of \$0.26 million for the quarters ended March 31, June 30, September 30 and December 31, 2006 and \$0.40 million, \$2.65 million and \$(0.15) million in the quarters ended March 31, June 30 and September 30, 2007.

(2) Reflects depreciation and amortization expense in 2006 and 2007 of \$0.60 million, \$0.76 million, \$0.76 million and \$0.79 million in the quarters ended March 31, June 30, September 30 and December 31, 2006 and \$0.82 million, \$0.85 million and \$0.93 million in the quarters ended March 31, June 30 and September 30, 2007.

	2005 Quarter Ended (unaudited)				2006 Quarter Ended (unaudited)			
	Mar. 31,	June 30,	Sept. 30,	Dec. 31,	Mar. 31,	June 30,	Sept. 30,	Dec. 31,
	(% of annual amount)				(% of annual amount)			
Net sales	20.7%	25.2%	25.8%	28.3%	22.9%	26.5%	25.0%	25.6%
Gross profit	20.9%	24.6%	26.0%	28.5%	24.0%	26.8%	24.9%	24.3%
Operating income	19.2%	30.2%	31.3%	19.3%	27.6%	37.4%	22.4%	12.6%
Net income	19.6%	29.9%	30.8%	19.7%	27.9%	37.2%	22.5%	12.4%

Our quarterly results of operations fluctuate depending on the timing of our advertising expenses and the timing of and income contributed by new stores. Our performance has also been impacted by



## **Table of Contents**

certain of our initiatives to improve our infrastructure and to position our business to support sustainable growth and profitability in the future, including in particular the hiring of additional management personnel in the second half of 2006, as well as the steps we took to optimize inventory levels in the fourth quarter of 2006.

Our net sales also fluctuate slightly as a result of seasonal factors. We experience slightly higher net sales in spring and fall, when more home remodeling and home building activities are taking place, and slightly lower net sales in holiday periods and during the hottest summer months. These seasonal fluctuations, however, are minimized to some extent by our national presence, as markets experience different seasonal characteristics.

## **Liquidity and Capital Resources**

We have historically funded our operations primarily through cash flows from operations and short-term and long-term borrowings under our senior secured loan agreement. Historically, our principal liquidity requirements have been to meet our working capital and capital expenditure needs.

Our principal sources of liquidity as of September 30, 2007 consisted of \$5.7 million in cash and cash equivalents and \$17.8 million of availability under our new \$25.0 million revolving credit facility.

We will use proceeds from this offering to repay all amounts outstanding under the term-loan portion of our senior secured loan agreement and our new revolving credit agreement (approximately \$14.1 million in aggregate as of September 30, 2007). We will use the remainder of the proceeds for general corporate purposes, including providing additional long-term capital to support the growth of our business (primarily through opening new stores) and maintaining our existing stores.

## ***Cash and Cash Equivalents***

During the first nine months of 2007, cash and cash equivalents increased \$1.7 million to \$5.7 million. Operating activities provided \$3.4 million, and proceeds provided by borrowings were \$6.4 million, partially offset by the use of \$4.8 million to purchase property and equipment and \$1.8 million used to repay scheduled principal on long-term debt and capital leases. During the first nine months of 2006, cash and cash equivalents decreased \$1.7 million to \$4.4 million, as \$0.9 million of cash provided by operating activities and \$1.1 million in proceeds provided by borrowings were more than offset by \$2.1 million used to purchase property and equipment, and \$1.6 million used to repay scheduled principal on long-term debt and capital leases.

The primary contributors to the decrease in cash and cash equivalents during 2006 were the use of \$2.7 million of cash for purchases of property and equipment and \$1.8 million of cash to repay scheduled long-term debt outstanding under the term-loan portion of our senior secured loan agreement, partially offset by \$1.4 million of cash provided by operating activities and borrowings of \$1.5 million under our revolving loan agreement. In 2005, cash and cash equivalents increased \$3.0 million, to \$6.0 million, from \$3.0 million at the end of 2004. The primary contributor to the increase in cash and cash equivalents during 2005 was \$8.0 million of cash provided by operating activities and borrowings of \$2.1 million under our senior secured loan agreement, partially offset by the use of \$4.3 million of cash for purchases of property and equipment and \$3.0 million of cash to repay long-term debt outstanding under our senior secured loan agreement.

## ***Cash Flows***

**Operating Activities.** Net cash provided by operating activities was \$3.4 million for the nine months ended September 30, 2007 and \$0.9 million for the nine months ended September 30, 2006. This increase in net cash provided by operating activities resulted primarily from changes in working capital,

## Table of Contents

particularly an increase in customer deposits and store credits, partially offset by a greater increase in inventory levels, a lower increase in accounts payable and a decrease in net income in the first nine months of 2007 compared to the first nine months of 2006.

Net cash provided by operating activities was \$1.4 million for 2006, \$8.0 million for 2005 and \$6.1 million for 2004. Net cash provided by operating activities decreased in 2006 compared to 2005 primarily because of increased inventory levels, partially offset by growth in net income and increases in accounts payable. The increase in inventory levels and increases in accounts payable resulted from our need to support additional sales from newly opened stores and increasing comparable store sales. In addition, we increased inventory, primarily in our Toano distribution facility, to be in a better position to drive sales and meet customer demand. Net cash provided by operating activities increased in 2005 compared to 2004 because of the growth in net income and increases in customer deposits, partially offset by decreases in accounts payable resulting from changing inventory levels, in part relating to discounted year-end purchases to take advantage of year-end supplier discounts which were particularly available in 2005.

**Investing Activities.** Net cash used in investing activities was \$4.8 million for the nine months ended September 30, 2007 and \$2.1 million for the nine months ended September 30, 2006. Net cash used in investing activities during 2007 primarily related to capital purchases of truck trailers that we use to move our merchandise from our warehouse to our stores, new store capital needs (primarily store fixtures and leasehold improvements), and information technology ( IT ) costs, including costs related to our new point of sale system and routine purchases of computer hardware and software. Net cash used in investing activities during the nine months ended September 30, 2006 primarily related to new store capital needs and an upgrade of our telephone system and website.

Net cash used in investing activities was \$2.7 million for 2006, \$4.3 million for 2005 and \$7.6 million for 2004. Net cash used in investing activities in 2006 primarily related to IT systems, including new hardware and upgrades to our telephone system and website, as well as new store capital needs. In 2006, we slowed the increase in new store locations as we expanded our store support infrastructure to better facilitate sustainable growth of our operations. Net cash used in investing activities in 2005 primarily related to purchases of truck trailers, IT system maintenance and new store capital needs. Net cash used in investing activities in 2004 primarily related to the completion of our finishing line in Toano, the purchase of truck trailers, the acquisition of Hardwood Holdings, LLC and new store capital needs and similar capital needs at our Toano facility.

We expect that our capital expenditures for 2007 will be approximately \$7.0 million, relating primarily to store fixtures and leasehold improvements for new stores, as well as additional trailers, upgrades to our finishing line and IT costs relating to our new point-of-sale system, maintenance and our website. We had opened 20 new store locations through September 30, 2007, and we intend to open at least 25 new stores in total during 2007 and between 30 and 40 new stores during each of the next several years thereafter. We believe that our cash flow from operations, together with our existing liquidity sources and the net proceeds from this offering, will be sufficient to fund our operations and anticipated capital expenditures over at least the next 24 months.

**Financing Activities.** Net cash provided by (used in) financing activities was \$3.0 million for the nine months ended September 30, 2007 and (\$0.5) million for the nine months ended September 30, 2006. Net cash provided by financing activities for both periods was attributable to borrowings under our revolving credit facility, offset by principal payments on our senior loan agreements and capital lease obligations. In the nine month period ended September 30, 2007, we used \$1.6 million for the payment of IPO costs.

Net cash (used in) provided by financing activities was \$(0.8) million for 2006, \$(0.7) million for 2005 and \$1.4 million for 2004. Net cash used in financing activities for 2006 was primarily attributable to the use of \$1.8 million to make principal payments on our senior secured loan agreement, partially

---

**Table of Contents**

offset by an increase of \$1.5 million in borrowings. Net cash used in financing activities during 2005 was primarily attributable to principal payments on our senior loan agreements, partially offset by an increase of \$2.1 million in borrowings. Net cash used in financing activities during 2004 was primarily attributable to the distribution of \$42.6 million to Tom Sullivan in that year, including \$12.6 million of distributions primarily related to our status as an S corporation and a \$30.0 million distribution related to the sale of the preferred stock, partially offset by an increase of \$35.0 million reflecting the proceeds from the sale of preferred stock to TA Associates and an increase of \$11.9 million in borrowings under senior loan agreements and our equipment-related line of credit.

***Senior Secured Loan Agreement***

In March 2006, we entered into an amended and restated senior secured loan agreement with Bank of America, N.A. ( Lender ), which was amended in July 2006 to increase the size of the revolving credit facility. Under the agreement, we have a term loan with an original principal amount of \$9.9 million and a revolving credit facility of up to \$10.0 million. We are required to repay the principal amount under the term loan in 60 equal monthly installments with the first payment due on April 1, 2006 and the final payment due on March 1, 2011. The revolving credit facility was repaid in full in connection with our entry into a new revolving credit agreement in August 2007.

The term loan portion of the senior secured loan agreement bears interest on the outstanding balance at a per annum rate equal to the Base Rate (generally equal to one-month LIBOR (floating daily), subject to adjustments in certain circumstances) plus the Applicable Margin (as defined in the facility). The Applicable Margin depends on the Funded Debt to EBITDAR Ratio (as defined in the facility), and can range from 0.45% to 1.15% so long as the Base Rate is linked to one-month LIBOR (floating daily). As of December 31, 2006 and September 30, 2007, the Applicable Margin was 0.90%, and the rate at which we accrued interest was 6.2% and 6.0%, respectively. We are required to pay an unused commitment fee of 0.25% per annum on undrawn amounts under the revolving credit facility.

The senior secured loan agreement and related security agreement contain a number of restrictions that will require us to maintain certain financial ratios and limit our ability, among other things, to borrow money, pledge our inventory or other assets as security in other borrowings or transactions, undergo a merger or consolidation, guarantee certain obligations of third parties, make or extend credit other than on ordinary terms in the course of our business or engage in any activity not reasonably related to those we presently conduct.

We were in compliance with all of our covenants under the loan agreement as of December 31, 2006 and September 30, 2007. As of December 31, 2006, we had remaining obligations of \$9.1 million, to repay amounts outstanding under the loan agreement. We refinanced amounts outstanding under the revolving facility portion of our senior secured loan agreement in August 2007 when we entered into our new revolving credit agreement. As of September 30, 2007, we had remaining obligations of \$6.9 million under the term-loan portion of our senior secured loan agreement

***Revolving Credit Agreement***

In August 2007, we entered into a new revolving credit agreement to replace the revolving credit facility under the senior secured loan agreement. We can borrow up to \$25.0 million under the new agreement, which expires on August 10, 2012.

Amounts outstanding under the new revolving credit agreement bear interest at a per annum rate equal to BBA LIBOR (equal to one-month LIBOR (reset on the 10<sup>th</sup> of the month), subject to adjustments in certain circumstances) plus the Applicable Margin (as defined in the revolving credit agreement). The Applicable Margin depends on the Funded Debt to EBITDA Ratio (as defined in the agreement), and can range from 0.50% to 1.00%. As of September 30, 2007, the Applicable Margin was 0.50%, and the rate at which we accrued interest was 6.3%. The agreement permits letters of credit to be drawn in an aggregate amount of \$5.0 million and has no mandated payment provisions. We are required to pay an unused commitment fee of 0.125% per annum, which may be increased in the future based on financial performance criteria, on undrawn amounts under the agreement.

**Table of Contents**

The revolving credit agreement and related security agreement contain a number of restrictions that will require us to maintain certain financial ratios and limit our ability, among other things, to borrow money, pledge our inventory or other assets as security in other borrowings or transactions, undergo a merger or consolidation, guarantee certain obligations of third parties, make or extend credit other than on ordinary terms in the course of our business or engage in any activity not reasonably related to those we presently conduct.

We were in compliance with all of our covenants under our revolving credit agreement as of September 30, 2007 and, as of that date, had outstanding obligations of \$7.2 million thereunder.

**Issuance of Preferred Stock**

In December 2004, funds managed by TA Associates purchased 7,952,018 shares of series A convertible preferred stock, par value \$0.01, for \$35.0 million. In connection with this sale, we declared a 150,000:1 common stock dividend to increase the number of common shares held by Tom from 100 to approximately 15.0 million. The stock split was effected in order to ensure that Tom would continue to hold an appropriate percentage of our common stock upon conversion of the convertible preferred stock held by TA Associates on a 1 for 1 basis. We distributed \$42.6 million in cash to Tom in 2004, including \$30.0 million of the proceeds from the sale of the convertible preferred stock (which represented a significant dilution of his ownership interest), \$5.0 million to enable him to pay taxes on deemed income during the period we were an S corporation and \$7.6 million of additional cash. We retained \$5.0 million of cash from the sale of our Series A convertible preferred stock for general working capital purposes and to provide operating liquidity. As a result of those cash distributions, we had a total stockholders deficit of \$30.2 million as of December 31, 2004, which has steadily improved to stockholders equity of \$4.1 million as of September 30, 2007. In connection with this offering, TA Associates has agreed to convert all of the outstanding shares of series A convertible preferred stock that it holds into shares of common stock. For additional information about the investment by TA Associates, see Certain Relationships and Related Party Transactions Investment by TA Associates.

**Related Party Transactions**

Tom Sullivan is the sole owner of ANO LLC, DORA Real Estate Company, LLC and Wood on Wood Road, Inc., and he has a 50% membership interest in BMT Holdings, LLC (collectively, ANO and Related Companies ). We leased our Toano facility, which includes a store location, and 25, 22 and 12 of our other store locations from these entities as of December 31, 2006, 2005 and 2004, representing 28.6%, 30.3% and 22.8% of total store leases, respectively. As of September 30, 2007, we leased our Toano facility and 26 of our other store locations from these entities, representing 24% of total store leases. The operating lease for our Toano facility has a base period through December 31, 2019. See Certain Relationships and Related Party Transactions.

**Contractual Commitments and Contingencies**

Our significant contractual obligations and commitments as of December 31, 2006 and September 30, 2007 are summarized in the following tables:

	Total	Payments Due by Period			
		Less Than 1 Year	1 to 3 Years	3 to 5 Years	5+ Years
		(in thousands)			
<b>Contractual obligations(1)</b>					
<i>As of December 31, 2006</i>					
Debt obligations	\$ 9,283	\$ 2,804	\$ 4,009	\$ 2,470	\$
Variable rate interest on debt obligations(2)	1,127	463	556	108	
Operating lease obligations(3)	31,384	5,548	9,463	5,531	10,842
Capital lease obligations, including interest(3)	330	269	61		
Supplier purchase commitments(4)	68,185	11,560	42,798	13,827	
Total contractual obligations	\$ 110,309	\$ 20,644	\$ 56,887	\$ 21,936	\$ 10,842



**Table of Contents**

	Total	Payments Due by Period			
		Less Than 1 Year	1 to 3 Years	3 to 5 Years	5+ Years
<b>Contractual obligations(1)</b>					
<i>As of September 30, 2007</i>					
Debt obligations	\$ 14,165	\$ 9,225	\$ 3,952	\$ 988	\$
Variable rate interest on debt obligations(5)	781	376	374	31	
Operating lease obligations(3)	42,290	7,454	12,636	8,134	14,066
Capital lease obligations, including interest(3)	110	103	7		
Supplier purchase commitments(4)	47,959	25,376	22,583		
Total contractual obligations	\$ 105,305	\$ 42,534	\$ 39,552	\$ 9,153	\$ 14,066

- (1) This table excludes the \$35.0 million redemption amount of our series A convertible preferred stock. This table includes amounts outstanding under our term loan, in accordance with its maturity schedule, as set forth in our senior secured loan agreement and our new revolving credit facility. Upon consummation of this offering, the term loan and the amount outstanding under the revolving credit facility will be repaid in full.
- (2) As of December 31, 2006, our senior secured loan agreement accrued interest at a rate of one-month LIBOR plus 0.90%, and the rate at which we accrued interest was 6.2%. We estimated our obligation under this agreement by assuming that interest will accrue at the December 31, 2006 rate until the loan agreement expires.
- (3) Included in this table is the base period or current renewal period for our operating leases. We lease certain buildings and equipment under non-cancelable operating leases and certain transportation equipment under non-cancelable capital leases. The leases expire at various dates through 2017 (2019 in the case of the lease for our Toano facility). The operating leases generally contain renewal provisions for varying periods of time.
- (4) We have one long-term purchase agreement with a merchant vendor that we entered into in July 2006 that requires us to purchase approximately 27 million square feet of product over a four-year period ending August 2010. The agreement provides for a set menu of products, including prices and specifications, from which we can pick in placing our orders, and provides for a detailed process by which either party can request a change in prices or specifications, or add or delete products from the menu. In the table above, our commitment for less than one year was calculated using actual purchase commitments, while the commitment for subsequent years was calculated using our actual commitments, where applicable, plus our estimated remaining commitments under that agreement.
- (5) As of September 30, 2007, our senior secured loan agreement accrued interest at a rate of one-month LIBOR plus 0.90%, and the rate at which we accrued interest was 6.0%. We estimated our obligation under this agreement by assuming that interest will accrue at the September 30, 2007 rate until the loan agreement expires.

**Off-Balance Sheet Arrangements**

We currently do not have any off-balance sheet arrangements or other financing activities with special-purpose entities.



## **Table of Contents**

### **Qualitative and Quantitative Disclosures About Market Risk**

**Interest Rates.** Because our senior secured loan agreement and our new revolving credit agreement bear interest at a variable rate, we are exposed to market risks relating to changes in interest rates. Both agreements, which we expect to repay in full upon completion of this offering, bear interest at a variable rate, adjusted annually, based on our performance under certain specified operating ratios. From inception at March 23, 2006 to August 10, 2007, our outstanding loans bore interest at a per annum rate equal to one-month LIBOR plus 0.90%. From August 10 to September 30, 2007 the senior secured loan agreement and our new revolving credit facility bore interest at a per annum rate equal to one-month LIBOR plus 0.90% and 0.50%, respectively. A hypothetical 100 basis-point increase from the current interest level on \$14.1 million, the aggregate amount outstanding under the term loan portion of our senior secured loan agreement and our new revolving credit facility at September 30, 2007, would result in approximately a \$0.1 million increase in interest expense over a one-year period. A hypothetical 100 basis-point decrease from the current interest level would result in approximately a \$0.1 million decrease in interest expense over a one-year period. We currently do not engage in any interest rate hedging activity and currently have no intention to do so in the foreseeable future. However, in the future, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

### **Inflation**

Inflationary factors such as increases in the cost of our product and overhead costs may adversely affect our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of gross profit and selling, general and administrative expenses as a percentage of net sales if the selling prices of our products do not increase with these increased costs.

### **Critical Accounting Policies and Estimates**

Critical accounting policies are those that we believe are both significant and that require us to make difficult, subjective or complex judgments, often because we need to estimate the effect of inherently uncertain matters. We base our estimates and judgments on historical experiences and various other factors that we believe to be appropriate under the circumstances. Actual results may differ from these estimates, and we might obtain different estimates if we used different assumptions or conditions. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements:

#### ***Recognition of Net Sales***

We recognize net sales for products purchased at the time the customer takes possession of the merchandise. We recognize service revenue, which consists primarily of freight charges for in-home delivery, when the service has been rendered. Net sales are reduced by an allowance for anticipated sales returns that we estimate based on historical sales trends and experience. Any reasonably likely changes that may occur in the assumptions underlying our allowance estimates would not be expected to have a material impact on our financial condition or operating performance. In addition, customers who do not take immediate delivery of their purchases are generally required to leave a deposit of up to 50% of the sales amount with the balance payable when the products are delivered. These customer deposits benefit our cash flow and return on investment capital, since we receive partial payment for our customers' purchases immediately. We record these deposits as a liability on our balance sheet under the line item Customer Deposits and Store Credits until the customer takes possession of the merchandise.

## Table of Contents

### **Equity Compensation**

We currently maintain a single equity incentive plan under which we may grant non-qualified stock options and incentive stock options to employees and non-employee directors. Using the prospective-transition method, we adopted the provisions of SFAS 123 (R) effective January 1, 2006. Prior to the adoption of SFAS 123 (R), we used the intrinsic value method under the provisions of Accounting Principles Board Opinion No. 25 (or APB 25). There were no material differences in the calculations of stock-based compensation expense under APB 25 and SFAS 123, *Accounting for Stock-Based Compensation* in 2005 or 2004. We recognize expense for our stock-based compensation based on the fair value of the awards that are granted. Measured compensation cost is recognized ratably over the service period of the related stock-based compensation award.

The fair value of stock options was estimated at the date of grant using the Black-Scholes-Merton valuation model. In order to determine the related stock compensation expense, we used the following assumptions:

Expected life of 7.5 years;

Expected stock price volatility of between 35% and 39%, based on the median volatility of companies in a peer group;

Risk-free interest rates from 4.6% to 5.2%; and

Dividends are not expected to be paid in any year.

In addition, we are party to the Variable Plan, a stock-based agreement between Tom Sullivan and Kevin Sullivan, pursuant to which we generally guarantee Tom's cash payment obligation under the agreement. We account for that agreement as a variable performance plan. Under the Variable Plan, as amended in August 2005, Kevin has the right to a fixed ownership percentage of Lumber Liquidators, Inc. on a fully diluted basis, plus an additional ownership percentage based on certain performance criteria (primarily a comparison of the net income of the region under his management to our total net income on a trailing twelve-month basis). In order to determine the compensation expense to be recorded, we are required to determine the net income of the region under his management, which requires us to make certain estimates.

Management estimated the fair value of our common stock based on contemporaneous valuations utilizing a market-approach model. We used this approach to value our common stock in retrospectively determining stock-based compensation expense as of December 31, 2003, 2004 and 2005, and to establish contemporaneous fair values of equity instruments for our equity grants in 2006 and April 2007. For the second and third quarters of 2007, however, management determined that the IPO process had progressed to such an extent that a different valuation methodology (based on estimating the company's fair value as a public entity, and then applying a marketability discount) could be used to measure fair value, and accordingly used that methodology in determining stock compensation expense. We will make valuation determinations for the option grants and restricted stock unit grants that we intend to make (subject to approval by our board of directors) in connection with the IPO using the actual IPO price, and thereafter expect to use the market value of the common stock on any date on which any such determination is required to be made.

A variety of qualitative and quantitative factors were considered in making these equity valuation determinations, including the state of the economy and the industry in which we operate, milestones that the company and its management had achieved and the appropriate marketability discount. We discuss our market and our achievements to date elsewhere in this prospectus, including in the sections entitled *Management's Discussion and Analysis of Financial Condition and Results of Operations* and *Business*. A marketability discount was also applied in each case, which management determined to be reasonable for each period based on the company's prospects for liquidity at that time and developments in its business and operations. This discount decreased over time as we improved various aspects of our

## **Table of Contents**

business and operations, including moving to a new facility, increasing the size of our product range, opening a significant number of new stores, hiring a number of key senior executives (including a new CEO), and implementing a number of operational, financial and governance policies to enhance our reporting and compliance functions.

We have not granted any stock options since April 2007. As of September 30, 2007, there were 1,846,847 stock options outstanding (including 50,000 stock options granted in April 2007), with an aggregate intrinsic value of \$9.7 million. Of these, 261,260 stock options with an intrinsic value of \$1.4 million were exercisable at September 30, 2007. See Note 4 to our unaudited condensed financial statements included elsewhere in this prospectus. Based on the offering price shown on the cover of this prospectus, the intrinsic value of the stock options outstanding at September 30, 2007 would have been \$6.0 million.

## ***Merchandise Inventories***

We value our merchandise inventories at the lower of merchandise cost or market value. We determine merchandise cost using the average cost method. All of the hardwood flooring we purchase from suppliers is either prefinished or unfinished, but is in immediate saleable form. To the extent that we finish and box unfinished products, we include those costs in the average unit cost of related merchandise inventory. In determining market value, we make judgments and estimates as to the market value of our products, based on factors such as historical results and current sales trends. Any reasonably likely changes that may occur in those assumptions in the future may require us to record charges for losses or obsolescence against these assets, but would not be expected to have a material impact on our financial condition or operating performance.

## **New Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48 ( FIN 48 ), *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109. FIN 48 describes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective as of January 1, 2007. The adoption of FIN 48 did not have a material effect on our financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS 157 ), which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the impact of SFAS 157 on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ( SFAS 159 ). SFAS 159 permits entities to choose, at specified election dates, to measure eligible items at fair value ( fair value option ) and to report in earnings unrealized gains and losses on those items for which the fair value has been elected. SFAS 159 also requires entities to display the fair value of those assets and liabilities on the face of the balance sheet. SFAS 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 will be effective for us as of the first quarter of 2008. Early adoption is permitted. We are currently evaluating the impact of SFAS 159 on our financial statements.

---

**Table of Contents**

**BUSINESS**

**Overview**

Lumber Liquidators is the largest specialty retailer of hardwood flooring in the United States, measured by total sales and based on information from *Floor Covering Weekly* and *Floor Focus* and our industry experience. We believe we have achieved a reputation for offering great value, superior service and a broad selection of high-quality hardwood flooring products. We offer an extensive selection of premium hardwood flooring products under multiple proprietary brands at everyday low prices designed to appeal to a diverse customer base. We believe that our vertically integrated business model enables us to offer a broad assortment of high-quality products to our customers at a lower cost than our competitors. We purchase prefinished and unfinished flooring directly from mills or associated brokers and work with our suppliers to control costs, develop new products and ensure superior product quality. Approximately 80% of our sales are to existing homeowners engaged in remodeling projects, and the remainder are to small independent contractors engaged in remodeling and new home building projects. As of September 30, 2007, we sold our products through 111 Lumber Liquidators stores in 42 states, a call center, our website and a catalog. We believe that our brands, value proposition and integrated multi-channel approach are important competitive advantages.

We offer hardwood flooring products from more than 25 domestic and exotic wood species in both prefinished and unfinished brands of various widths and lengths. Our products are differentiated in terms of quality and price based on the species, grade of the hardwood, quality of finishing, as well as the length of the warranty. We also offer a broad assortment of flooring enhancements and installation accessories including moldings, noise-reducing underlays and adhesives. Our product offering is substantially comprised of our proprietary brands, including our premium Bellawood brand as well as our Builder's Pride, Virginia Mill Works, Schôn, Morning Star Bamboo and Dream Home brands. We have experienced strong historical growth, including net sales growth from \$171.8 million in 2004 to \$332.1 million in 2006, operating income growth from \$7.2 million in 2004 to \$21.4 million in 2006 and net income growth from \$8.0 million in 2004 to \$12.9 million in 2006, representing compound annual growth rates of approximately 39%, 73% and 27%, respectively. In the first nine months of 2007, our net sales were \$299.8 million, which represents a 21% increase over the first nine months of 2006. Our operating income for the first nine months of 2007 declined to \$13.9 million from \$18.7 million in the first nine months of 2006, and our net income declined to \$8.3 million from \$11.3 million for the same periods. Our overall growth has been driven in large part by the opening of 86 stores since January 1, 2003 and our strong comparable store sales performance in each of those periods. On an annual basis, comparable store sales increased 19.0% from 2004 to 2005, and 17.3% from 2005 to 2006. In the first nine months of 2007, comparable store sales increased 8.6% over the first nine months of 2006, which increased 19.2% over the first nine months of 2005.

Our company started in 1994 when Tom Sullivan, the chairman of our board of directors, began selling discounted building materials. In 1996, he identified an opportunity to sell hardwood flooring at liquidator prices. Tom started selling unsold flooring products sourced directly from mills from a warehouse in Stoughton, Massachusetts, and in 1996, he opened the first Lumber Liquidators store near Boston, Massachusetts. Tom observed that traditional home improvement and flooring retailers underserved customers in terms of price, selection, product quality and overall value. Tom began working directly with vendors and mills to provide customers with broad, high-quality assortments at everyday low prices including in premium categories. He also identified the opportunity to better serve customers by employing knowledgeable sales staff to educate the customer about the product and provide advice on self-installation or working with contractors. In August 1996, Tom opened the second Lumber Liquidators store in Hartford, Connecticut, starting our company's national expansion. In 2000, we opened a central warehouse in Virginia and started operating our own finishing line. We subsequently moved to our current location in Toano, Virginia in 2004. The Toano facility contains our distribution

## **Table of Contents**

center and finishing line, where we currently finish approximately 70% of our premium Bellawood products. We maintain our in-house finishing capability to ensure product quality and to reduce third-party finishing costs.

We have made a significant investment in developing our national brands, including our portfolio of proprietary product offerings. We believe Lumber Liquidators is now recognized across the United States as a destination for high-quality hardwood flooring at everyday low prices, while our Bellawood brand is known as a premium flooring brand within the industry. We have developed a national store presence, with 111 locations in 42 states as of September 30, 2007. Our stores typically consist of a warehouse and an attached showroom located in industrial or commercial areas that have lower rents than traditional retail locations, are accessible from major roadways and have significant visibility to passing traffic. Our average store is approximately 6,400 square feet, of which approximately 800 square feet is devoted to the showroom selling area. We have designed our stores using a visually appealing and distinctive showroom format to enhance the customer experience while demonstrating our low-cost approach to doing business. Most of our stores have wall racks holding one-foot by two-foot display boards of our flooring products and a warehouse stocked with our most popular hardwood products and high-volume items. Each of our store associates participates in all aspects of our store operations and is trained to understand the characteristics and installation method for the broad range of hardwood floors in order to best educate our customers. We do not, however, provide installation services. We believe that our stores reinforce our customers' belief that they get a good deal when they buy from us.

## **Competitive Strengths**

We believe the following competitive strengths contribute to our leading market position, differentiate us from our competition and will drive our future growth.

### ***Attractive Store Economics***

We operate a store model that produces strong returns on investment by combining low capital investment, a small store footprint, minimal staffing and a high average sale of more than \$1,750 in 2006. We define average sale as the average invoiced sale per customer, measured on a monthly basis and excluding transactions of less than \$250 (which are generally sample orders, or add-ons or fill-ins to previous orders) and of more than \$30,000 (which are usually contractor orders). Our average new store across our markets has historically become profitable within three months of beginning operations and returned its initial cash investment within seven months. We estimate that the cost required to open a typical new store is approximately \$240,000, of which inventory, net of trade payables, represents approximately \$190,000. Our store model targets a pre-tax return on invested capital in excess of 140% for stores open more than three years (including all advertising costs). For the twelve months ended September 30, 2007, we did not have an unprofitable store on a four-wall basis in our portfolio (excluding stores open for less than three months). When measuring profitability on a four-wall basis, we take into account the sales and costs of sales at each individual store, as well as the expenses of that store, which include wages and benefits, rent and local advertising. We do not consider national advertising and store support costs, including those related to corporate overhead and our distribution facility, when calculating profitability on a four-wall basis. We believe the profitability of our store model is driven in part by our ability to carry broad product assortments, while maintaining limited in-store inventories. With the exception of certain high-volume products, we have found that customers typically give us a deposit for their purchases and request delivery of their products approximately one month after placing an order, which reduces our store-level working capital investment requirements and allows us to centrally manage inventory from our distribution facility in Toano. We initiate shipment of most products to a store after an order is placed by a customer, and we can time deliveries to meet our customers' specific circumstances. In cases where the customer orders for future delivery, we generally receive a

## Table of Contents

50% deposit, which benefits our cash flow and return on investment capital, because we receive immediate partial payment.

### ***Appealing Value Proposition***

Our value proposition to the customer is a key driver of our business. Important components include:

***Price.*** A fundamental part of our founding philosophy is to provide quality hardwood flooring brands at everyday low prices. We are able to maintain these prices across our product range because, unlike a majority of our competitors, we purchase our flooring directly from mills and associated brokers, thereby avoiding mark-ups by distributors. In addition, we operate a low-cost store model with a no frills showroom, limited in-store inventory and locations in industrial or commercial areas that are easily accessible and visible to passing traffic and carry lower rent expense than many retail stores.

***Selection.*** We have developed a broad product assortment of domestic and exotic hardwoods sold under proprietary brands that help us to differentiate our products from those of our competitors. We offer products across a range of price points and quality levels that allow us both to target discrete market segments and to appeal to diverse groups of customers. For example, we sell our Bellawood products to more affluent customers, while our engineered and laminate products are more popular with people seeking more economical flooring solutions.

***Quality.*** We believe that we have achieved a reputation for quality, and that our proprietary brands are recognized for excellence by our customers. We work directly with our supplier mills and brokers to produce flooring that will meet our high quality standards. We require our suppliers to prepare most of the products we sell to our specifications. We also currently finish approximately 70% of our premium Bellawood products at our state-of-the-art Toano facility. We maintain an in-house inspection and quality control function and enforce strict certification requirements for Bellawood supplier mills. As a result, we offer a 50-year residential warranty on our premier Bellawood brand, which we believe is the industry's longest. The multiple coats of natural stains and urethane-based sealers that we apply to Bellawood results in a product with one of the highest scuff resistant finishes in the industry. We monitor the consistency of products produced by our suppliers and work with them to maintain high milling standards.

***Availability.*** Since our founding, we have made it a priority to build long-term relationships with our key supplier mills and brokers. As we have grown, we believe our relationships with our suppliers have strengthened, which we believe helps us ensure our continued access to a broad selection of domestic and exotic hardwood products at attractive prices. In evaluating suppliers, one of the factors we consider is their access to new or hard-to-find species of wood, so that we can continue to expand our range of exotic hardwood products. We also seek out new mills that can meet our demanding standards, and we work with them to evaluate new hardwood species as well as new technologies that may allow us to expand or improve our operations. We believe that these direct supplier relationships are relatively unique in our industry, and offer us a significant competitive advantage. In addition, our centralized inventory at our Toano distribution facility allows us to deliver products not stocked in stores to our customers within a week of purchase or whenever it meets our customers' specific needs. Approximately 85% of our merchandise passes through this facility before we move it to our stores. We believe our supply chain and centralized inventory allow us to meet the delivery needs of our customers better than our competitors.

## **Table of Contents**

### ***Established National Brands***

We believe both Lumber Liquidators and Bellawood are well-known national brands. We have positioned Lumber Liquidators to represent an attractive value proposition to the customer, and believe we offer superior service and hardwood flooring expertise for customers seeking information about hardwood flooring. Based on our market research, we believe that Bellawood, which accounted for approximately one-third of our 2006 net sales, is among the most-recognized brands in the hardwood flooring industry. We are committed to supporting our brands and products through diverse national marketing campaigns, which have historically included TV, radio and print ads, as well as sports and television show sponsorships, including sponsoring a NASCAR truck racing team and television shows like *Extreme Makeover: Home Edition* and *This Old House*, that reach a wide variety of potential customers. In addition, we believe that we benefit from our long-term endorsement relationships with respected and well-known home improvement celebrities such as Bob Vila and Ty Pennington. Bob Vila has been associated with the Bellawood brand for several years, and Lumber Liquidators is the exclusive provider for that product. Ty Pennington, the star of *Extreme Makeover: Home Edition*, appeals to a younger demographic and is associated with the Lumber Liquidators and Bellawood brands, as well as with the signature Ty Pennington flooring brand that features a Bellawood finish and is sold exclusively through Lumber Liquidators.

### ***Integrated Multi-Channel Sales Model***

We have an integrated multi-channel sales model that enables our national store network, call center, website and catalog to work together in a coordinated manner. Due to the average size of the sale, many of our customers conduct extensive research before making a purchase decision. Our sales strategy emphasizes customer service by providing superior convenience and education tools for our customers to learn about our products and the installation process. Customers can view our complete assortment of products through each channel. We believe that potential new customers generally first come to know about us through our national advertising and other marketing efforts. For many of them, the next stop is our website, which provides an informational tool where they can start to learn about our wide variety of products. Our website also allows new customers to see before and after examples from previous customers, explains the installation process and provides product reviews and endorsements. Some customers also contact our call center, which is staffed by more than 50 flooring experts who are also available for online chat and email. Customers can order samples or a catalog through any of our sales channels. Customers who are ready to make a purchase can either visit one of our stores or place an order via our website or call center. We hire store associates who often have relevant industry experience, are able to guide customers through the purchasing process and can provide advice on installation, the selection of a contractor and maintenance. Once an order is placed, customers can either have purchases delivered or can pick them up at a nearby store location. We strive to use our various sales channels to make our customers' transactions easy and efficient.

### ***Experienced Management Team with a Proven Track Record***

Our senior management team has extensive experience with publicly traded, high-growth retail companies. We believe our company benefits in particular from the leadership of Tom Sullivan, our founder and the chairman of our board of directors, who is a veteran of the specialty hardwood flooring retail business. Under his guidance, we experienced rapid growth and established ourselves as a leading company in the industry. He continues to have an active role in determining our strategic direction and assisting with our day-to-day operations. We believe that his product knowledge and relationships with our suppliers are important competitive advantages. In addition, Jeff Griffiths, our president and chief executive officer, has more than 30 years of experience in the retail industry. He recently served as the president and chief executive officer of videogames retailer Electronics Boutique from 2001 to 2005. Our chief financial officer, Dan Terrell, has more than 15 years of experience working with reporting companies in the retail industry. Over the past two years, we have assembled a management team with

## **Table of Contents**

extensive experience in the specialty retail and hardline retail industries across a broad range of disciplines, including store operations, marketing, merchandising and information systems, production, distribution and finance. We intend to continue to leverage our management team's experience and acumen to execute our strategy effectively. Upon completion of this offering, our executive officers and directors will beneficially own 38% of our company (excluding shares owned by TA Associates funds).

### **Growth Strategy**

We intend to continue to increase revenues and profitability by strengthening our position as a leading provider of hardwood flooring within our growing market. Specific elements of our strategy for continued growth include the following:

#### ***Expand Our Store Base***

The hardwood flooring market is highly fragmented, and we believe there is a significant opportunity to expand our store base. Because of the low capital investment required to open new stores and the attractive returns on investment that our stores generate, we intend to continue to expand our store base. We plan to open at least 25 new stores in total during 2007 and between 30 and 40 new stores during each of the next several years thereafter. As of September 30, 2007, we had opened 20 new stores and had signed leases for seven additional stores during 2007. We believe that we have opportunities to expand our store presence in most of our existing markets, as many of our larger markets have only one or two stores. We also plan to open stores in new markets, leveraging our national advertising campaign, as we believe our store concept has broad national appeal and can be successful in a wide variety of large and small markets.

#### ***Improve Existing Store Sales Growth***

We seek to drive productivity through strong comparable store sales performance and by improving operational efficiencies. We expect that sales growth will be driven by our investment in our proprietary brands, targeted marketing campaigns and more efficient sales and inventory planning and forecasting. We also expect sales growth will be supported by favorable long-term industry trends, including increasing remodeling activity and consumer preference for hardwood flooring. In addition, we continue to build on what we believe is our strong track record of consistent store-level execution. We intend to maintain our low-cost store model for both our existing and new stores, to focus on increasing gross margins across our assortment of products and to focus on maintaining retail pricing discipline among our stores. We also incentivize our employees using commissions derived from store-level metrics. We plan to increase the number of product shipments from our suppliers directly to our stores, thereby saving delivery time and expense from our Toano facility.

#### ***Expand Operating Margins***

We attribute our success to our focus on and our ability to deliver on our value proposition to the customer, which results from leveraging our strength as a vertically-integrated, low-cost operator. As we continue to increase our revenues by opening new stores and marketing our proprietary brands, we also plan to decrease marginal costs by taking advantage of improving economies of scale in purchasing, leveraging our existing infrastructure and other fixed expenses, particularly general corporate overhead and lease expenses, and optimizing our finishing, distribution and supply chain management. We believe that we have built out our operations to be able to scale upward to sustain a high level of growth. For example, while we currently operate one finishing line at Toano, which we believe can support our planned growth for at least the next three years, we have the space to construct a second finishing line in the facility that would double our capacity. We believe the second finishing line would require limited incremental investment and could be funded through cash flow from operations. Similarly, we have designed our inventory and management information systems to be scalable as we expand our operations.



## Table of Contents

### ***Leverage Brand Marketing Across Multiple Channels***

We use our advertising and marketing activities and our multiple sales channels particularly our website and our call center to help educate potential customers about hardwood flooring. As customers learn more about hardwood flooring and how best to shop for it, they also learn more about our products and value proposition, which we believe drives customer store visits and purchases of our products. We believe that as we continue to leverage our multi-channel strategy, we will drive repeat customer traffic. We have also made a significant advertising and marketing investment to link our brands, particularly Lumber Liquidators and Bellawood, to quality and value as well as to establish ourselves as the hardwood flooring experts. We believe that opportunities exist to expand sales with marketing initiatives focused within and across each of our sales channels. For example, in February 2007, we conducted our first mass mailing of catalogs, and we have continued expanding our catalog mailing efforts to prospective customers. Based on our focus group research, we believe that more than 90% of our customers visited our website before making a purchase from us. Initiatives like these should enable us to more cost-effectively reach new customers and encourage previous customers to make additional purchases from us. As we continue to grow and open more stores, we believe that our marketing and branding activities will become more efficient and targeted. We also believe that our customer acquisition costs will decline on both a per-customer and per-store basis.

### **Our Market**

The hardwood flooring market represents approximately 10% of the overall U.S. floor coverings market, which includes carpet and area rugs, hardwood and softwood flooring, ceramic floor and wall tile, resilient sheet and floor tile and laminate flooring. In its 2005 Wood Flooring report, as subsequently updated in March, June and September 2007, Catalina Research estimates that the value of U.S. hardwood flooring wholesale sales in 2005 was approximately \$2.3 billion (representing retail sales of \$4.1 billion), and, in addition, estimated in November 2005 that the market would grow at a compound annual growth rate of 7.4% through 2011. Despite projected long-term growth, however, Catalina Research estimates that U.S. hardwood flooring sales declined 10.6% in 2006 and declined 14.1% in the first half of 2007 compared to the same period in 2006. Similar declines were estimated across most types of flooring, and were due in particular to decreased new housing demand. The majority of our sales, however, are to consumers engaged in remodeling projects, so despite these market declines, our net sales increased 36% from 2005 to 2006 and 21% from the first nine months of 2006 to the first nine months of 2007. Although we anticipate there may be some volatility in the near term due to decreased housing demand, which Catalina's growth estimate may not fully reflect, we believe we will continue to benefit from several key long-term industry trends and characteristics including:

***Increased Home Improvement Spending.*** Based on the U.S. Census Bureau construction report, residential improvement spending grew at a 7.0% compound annual growth rate from 2000 to 2005. According to the Home Improvement Research Institute, spending on home improvement products is forecasted to grow at a 5.2% compound annual growth rate from 2005 to 2010. The home improvement market is driven by several factors, which include the age of the existing housing stock, home ownership levels, average home size and demographic shifts in the population. We believe home improvement spending is currently being driven in particular by persons engaged in home remodeling projects.

***Aging Housing Stock.*** As homes get older, homeowners remodel in order to maintain habitability, marketability and attractiveness of the home. Also, as homes get older, materials such as floor coverings that were used at the time of initial construction wear out and must be replaced or upgraded to compete with new homes. According to the U.S. Census Bureau, the median age of the U.S. housing stock was 33 years in 2005, which compares to 25 years in 1990 despite record new home construction in recent years.

**Table of Contents**

***Increasing Home Ownership.*** Data from the U.S. Census Bureau shows that home ownership rates increased to 69% in 2006 from 65% in 1995. Homeowners are significantly more likely to spend on residential improvements than landlords and renters. According to the Joint Center for Housing Studies of Harvard University, homeowners increased their residential improvement expenditures 10% annually from 2000 to 2005, while owners of rental properties have increased their spending by less than 4% annually over the same period.

***Increasing Average Size of Homes.*** As homes have increased in average size, there is more floor surface to be covered. According to the U.S. Census Bureau, the average new single family home was estimated to be 2,434 square feet in 2005, a 16.2% increase from 2,095 square feet in 1995.

***Favorable Demographic Trends.*** Purchases by households with more discretionary income have driven increased hardwood flooring sales. Households with incomes of \$70,000 or more made approximately 49.4% of total hardwood surface flooring purchases in 2003, up from 32.8% in 1997. The population segment represented by this income bracket was one of the most quickly growing over the past decade. Similarly, households headed by people between 35 and 64 years of age represented 69.2% of total hard surface flooring purchases in 2003, up from 63.8% in 1997. This segment's population will continue to grow, as the U.S. Census Bureau projects the 45 to 64 age segment to increase to 26.2% of the population by 2010 (up from 22.1% of the population in 2000). This constitutes the largest population increase of any age group over that period.

***Evolution of the Hardwood Flooring Market.*** Manufacturers today offer a wider range of wood species than they have historically, including exotic woods and bamboo, as well as distressed and handscraped flooring lines that appeal to a wider range of consumers. Additionally, manufacturers have designed hardwood flooring that is increasingly easier and less costly to install, such as prefinished, engineered floors that can be installed without glue. Prefinished hardwood floors have become highly prevalent due to ease of installation, multiple styles and applications for situations that in the past precluded the use of hardwood floors. Unfinished products usually require professional installation, sanding and multiple coats of varnish. According to industry sources, the percentage of prefinished square feet of flooring sold increased from 38% in 1999 to 50% in 2004.

***Greater Attractiveness of Hardwood Flooring.*** Hardwood flooring sales have grown historically, and we expect that they will continue to grow as consumer preferences shift to hardwood flooring and as industry innovations drive growth, such as through a greater range of product offerings that appeal to varied consumer preferences and hardwood flooring that has been designed for easier and less costly installation. According to *Floor Focus*, hardwood represented an estimated 14% of the floor covering market in 2006, up from 6% in 1994. We believe that consumers increasingly prefer hardwood flooring for its perceived cosmetic and durability advantages, as well as its ability to contribute to a healthy home because it is relatively easy to clean and traps less dust, dirt and bacteria than some other types of flooring.

## Table of Contents

### **Our Products**

We offer a complete assortment of hardwood flooring that includes prefinished premium exotic hardwoods, engineered hardwoods, unfinished hardwoods and laminates. Our product offering is substantially comprised of our proprietary brands, and we plan to offer new proprietary brands in the future. Our hardwood flooring products are generally available in various widths and lengths. They are generally differentiated in terms of quality and price based on the species, grade of the hardwood and quality of finishing as well as the length of the warranty. In total, we offer nearly 350 different flooring product stock-keeping units ( SKUs ). Brands generally come either prefinished or unfinished. Prefinished floors are finished in a factory under controlled conditions and are ready to be enjoyed immediately after they are installed. Our prefinished products generally have warranties ranging from 10 to 50 years when used in residential settings, and three to five years when used in commercial settings. We check the quality of our prefinished products using a variety of testing methods. Unfinished hardwood flooring is sanded and finished several times after installation, typically by professional flooring contractors. In addition, some brands have specialized features that appeal to particular customer needs. For example, engineered hardwood products are better suited to areas with higher moisture, because they are less affected by changes in humidity. We also offer a broad assortment of flooring enhancements and installation accessories, including moldings, noise-reducing underlay, and adhesives, that complement our assortment of floor offerings.

The graphic below sets forth the percentage of our 2006 net sales that we derived from each product category:

### **Hardwood**

**Solid Hardwood.** Our proprietary solid hardwood products are milled from one thick piece of wood, which can be sanded and refinished numerous times. We offer flooring products made from more than 25 wood species, including both domestic woods, such as ash, beech, birch, hickory, northern hard maple, northern red oak, pine and American walnut, and exotic woods, such as bloodwood, cherry, cypress, ebony, koa, mesquite, mahogany, rosewood and teak. We offer a 50-year residential warranty, which we believe is the industry's longest, on our premier Bellawood brand (including the Ty Pennington Collection) because the multiple coats of natural stains and urethane-based sealers that we apply to them produce a product with one of the highest scuff resistant finishes in the industry (as measured by the Taber Abrasion Test). In 2006, Bellawood flooring accounted for approximately one-third of our total flooring sales.

**Table of Contents**

Our proprietary solid hardwood flooring offerings are described in the following table:

<b>Brand</b>	<b>Domestic/ Exotic Wood</b>	<b>Prefinished/ Unfinished</b>	<b>Residential Warranty (years)</b>	<b>SKU Count</b>	<b>Other Characteristics</b>
Bellawood	Both	Prefinished	50	125	Our premium brand; easy to install, with a high-abrasion UV-cured aluminum oxide finish
Ty Pennington Collection	Both	Prefinished	50	5	Unique solid hardwood floors selected by Ty Pennington and featuring a Bellawood finish
Builder's Pride by Dura-Wood	Both	Prefinished	25	40	Solid hardwood for the value-conscious consumer
Virginia Mill Works Co. Handscraped Solid	Domestic	Prefinished	25	9	Handscraped and distressed floors that evoke those found in Colonial American homes
Casa de Colour Collection by Dura-Wood	Domestic	Prefinished	25	35	Solid oak and maple, stained to enhance the natural wood tones
Clover Lea Plantation	Domestic	Both	None	14	Solid pine
R. L. Colston & Sons	Both	Unfinished	None	88	Solid hardwood

**Engineered Hardwood.** Our proprietary engineered hardwood products are produced by bonding a layer of hardwood to a plywood backing. Like our solid hardwood floors, our engineered hardwood floors are offered in domestic and exotic wood species. All of our engineered hardwood products are prefinished. One brand, Schön 4 Single Strip Quick Clic, allows for easy-click installation, in which the floors click together and float above the sub-floor instead of being nailed or glued into place. Our proprietary engineered hardwood flooring offerings are described in the following table:

<b>Brand</b>	<b>Domestic/ Exotic Wood</b>	<b>Residential Warranty (years)</b>	<b>SKU Count</b>	<b>Other Characteristics</b>
Schön Engineered Floors	Both	30	8	Extra-thick solid hardwood wear layer, approved for below-grade installation
Schön 4 Single Strip Quick Clic	Both	30	19	Floating wood floors featuring single strip boards and easy-click installation
Virginia Mill Works Co. Engineered	Domestic	30	11	Handscraped and distressed floors that evoke those found in Colonial American homes
Timber Top Engineered Wood Floors	Both	15	13	Have a thinner wood top layer; designed for the more value-conscious consumer

**Table of Contents**

**Bamboo and Cork.** Bamboo and cork are ecologically friendly choices in flooring that have gained in popularity due to their greater renewability, which we believe appeals to environmentally conscious customers. Bamboo is one of the fastest growing plants and has an extensive root system that creates new bamboo shoots without replanting. Cork flooring, which is durable, acoustical and an insulator, is produced by harvesting the outer bark of the cork oak tree, and the same tree can be harvested numerous times. Our proprietary bamboo and cork flooring offerings are described in the following table:

<b>Brand</b>	<b>Easy-Click Installation</b>	<b>Residential Warranty (years)</b>	<b>SKU Count</b>	<b>Other Characteristics</b>
Schön Engineered Floating Bamboo Floors	Yes	30	4	Features easy-to-install quick-click installation and an extra-thick wear layer
Morning Star Bamboo Flooring	No	30	14	Our premier bamboo line, made with 4+ year old bamboo to increase hardness
Ty Pennington Collection	No	30	3	Premium quality bamboo floors selected by Ty Pennington
Lisbon Cork Co. Ltd.	Yes	25	4	Made from real cork; durable; comfortable cushioned surface
Supreme Bamboo by Eco-World Flooring Co.	No	15	4	Designed for the more value-conscious consumer

**Laminate.** Our proprietary laminate flooring is typically constructed with a high-density fiber board core, inserted between a melamine laminate backing and high-quality photographic paper displaying an image of wood and a ceramic finish, abrasion-resistant laminate top. These products are produced and assembled to our specifications by third parties. Some of our laminate flooring brands allow for easy-click installation or V-groove installation, while others offer a pre-glued undersurface, moisture repellent, soundproofing, single-strip format or a handscraped textured finish. Residential warranties range from 10 to 30 years. We offer various brands and 27 SKUs of laminate flooring in 6mm, 7mm, 8mm and 12mm thicknesses.

**Moldings, Accessories and Other Products.** We offer a wide variety of hardwood flooring accessories. For example, we sell stair treads and moldings that complement our hardwood floor products. We also sell underlays that can be placed between the new floor and the sub-floor, which insulate sound and cushion the floors. In addition, we sell installation supplies (such as adhesive and trowels), floor cleaning supplies and butcher-block kitchen countertops.

**Multiple Integrated Sales Channels**

We sell our products through four integrated sales channels, consisting of our stores, call center, website and catalog. We believe that our sales strategy enhances customer service because it provides superior convenience and facilitates the customer's purchasing decision. We provide customers with tools to learn about hardwood flooring and the installation process and give them the ability to view our complete assortment of products through each channel. This integrated process produces operational benefits that improve market penetration and returns on capital.

## **Table of Contents**

Our approach is based on our belief that customers prefer to shop for flooring using multiple channels. Since hardwood flooring is an infrequent purchase for many of our customers, we believe that we increase our chances of making a sale if we are the consumer's choice for expert service at each step of their purchasing decision, from initial education about hardwood flooring to guidance on best maintenance practices for their installed flooring. Our national advertising strategy is designed to raise awareness of our brand and to establish Lumber Liquidators as the first destination for customers who are in the early stages of a purchase decision. Our other marketing efforts, our website and our catalog are similarly designed to both sell products and to provide customers with information throughout the purchasing process. Our research indicates that by the time a customer enters one of our stores, he or she has generally researched our offerings on our website or in our catalog and is ready to make a purchase.

Customers can purchase our products in our stores, or through our call center or website, and can either have those purchases delivered directly to their homes or arrange to pick them up at a nearby store location. With the exception of certain high-volume products, we have found that customers typically expect to take delivery of their products approximately one month after placing an order. Customers who do not take immediate delivery must generally leave a deposit of approximately 50% of the retail sales amount, with the balance payable when the products are delivered. The prices available on our website and from our call center are the same as the prices in our stores.

### **Stores**

We have developed a national store presence, with 111 locations in 42 states as of September 30, 2007. Most of our stores are currently located in primary or secondary metropolitan areas, but we have also succeeded in a number of smaller markets. At present, we generally have no more than two stores in each major metropolitan market, and there are many small and medium-sized markets where we have no stores at all. In identifying new markets, we intend to target selected markets that have demographic and other characteristics similar to those where we have been successful and fill in larger markets with additional stores.

In 2006, our stores that had been open for more than twelve months had average per-store sales of \$4.2 million, and we have experienced strong comparable store sales in each of the last four years. Our stores are designed to reflect our low-cost approach to doing business, and consist of a large warehouse and a small attached showroom. The average size of our stores is approximately 6,400 square feet, of which approximately 800 square feet is dedicated to the showroom selling area. We seek buildings that are typically located in industrial or commercial areas that have lower rents than traditional retail locations, are accessible from major roadways and have significant visibility to passing traffic. We enter into short leases, generally for terms of five years, to maximize our real estate flexibility. Our store model targets a pre-tax return on invested capital in excess of 140% for stores open more than three years (including all advertising costs). For the twelve months ended September 30, 2007, we did not have an unprofitable store on a four-wall basis in our portfolio (excluding stores open for less than three months).

We have engaged a national broker to assist us with identifying locations for new stores and negotiating with landlords. After the broker has identified a new site, members of our management team visit the site, and it is reviewed for final approval by our real estate committee. Our first priority is to expand into markets in which we currently do not have a store, or where our existing store is more than an hour's drive away from what we believe is a critical mass of potential customers. We also focus on high density markets that we feel can support multiple stores. In the past, the size of our stores has varied depending on our ability to acquire space opportunistically, but we expect that new stores will generally be between 5,000 and 8,000 square feet, with approximately 800 square feet dedicated to the showroom and the remaining space used as a warehouse.

**Table of Contents**

The table below highlights certain information regarding our stores open during each of the five years ended December 31, 2006 and the nine months ended September 30, 2007.

	2002	2003	2004	2005	2006	Nine Months Ended September 30, 2007
Number of stores at beginning of period	23	25	40	57	76	91
New stores	2	15	17	19	16	20
Closed stores(1)					(1)	
Number of stores at end of period	25	40	57	76	91	111

(1) The 2006 closed location represents a laminate flooring-only store established to operate during the remaining lease period of a relocated store.

Consistent with our low-cost focus, the layout of our stores is simple and includes design elements that consumer research suggests influence purchasing decisions. Our store design is intended to be both informative and functional. For example, wall displays in our stores show a selection of one-foot by two-foot displays of our flooring products, while the floors are generally laid with various examples of the hardwood flooring products we carry. Our research shows that customers correlate our simple, functional store designs and locations outside of high-rent retail areas with a belief that they have received good value for the money they have spent on our products.

A typical store that has been open for more than 12 months is staffed by a store manager and two assistant managers. We hire additional staff to the extent required by a store's level of business. The store manager is responsible both for store operations and for overseeing our customers' shopping experience. Many of our store managers have previous retail experience with large retailers in the home improvement industry, the retail flooring industry or the flooring installation industry. Store manager compensation consists of a base salary and commissions.

Average store inventory is approximately \$365,000 and consists of both in-stock inventory and order-specific inventory. Our in-stock inventory is generally comprised of high-volume merchandise that our customers prefer to have available at the time of purchase. Products in this category include laminates, bamboo and certain accessories. We stock most of our other products at our Toano distribution facility, from which we can deliver products to our customers across the country within a week.

We expanded our store base by 19 stores in 2005 and 16 stores in 2006. We plan to open at least 25 new stores in total during 2007 and between 30 and 40 new stores during each of the next several years thereafter. As of September 30, 2007, we had opened 20 new stores and had signed leases for seven additional stores in 2007. We intend to continue to expand our store base in the future. Since we began operations, we have closed only one location, a laminate flooring-only store established to operate during the remaining lease period of a relocated store. Our average new store across our markets has historically become profitable within three months of beginning operations and returned its initial cash investment within seven months.

**Call Center**

More than 50 flooring experts cross-trained in sales, customer service and product support staff our call center. In addition to receiving telephone calls, our call center staff has recently been made available to chat online with visitors to our website, respond to e-mails from our customers and engage in telemarketing activities. Customers can contact our call center to place an order to be delivered directly

## **Table of Contents**

to their home or picked up at a nearby store, to make an inquiry or to order a catalog. Callers can also order flooring samples for a nominal fee that is credited towards their first purchase. Our call center uses a scalable Internet-based telephone system that allows for rapid movement of our telephone handsets as needed to any available Internet connection. Our call center staff work on a commission basis. Call center sales fulfilled through our Toano distribution facility are credited to the call center, while those picked up at one of our stores are credited to that store. If the sales credited to the various stores were instead credited to our call center, our call center would constitute our largest store by sales volume.

## ***Website***

Our website ([www.lumberliquidators.com](http://www.lumberliquidators.com)) serves both to educate consumers and to generate sales, whether through a store, our call center or directly via the website itself. Potential customers want information about the products they are considering, and we seek to provide them with what they need to make an informed decision. Visitors to our website can interact with our flooring experts via live chat and can search through a large database of frequently asked questions we call Flooring 101. We also offer product reviews and an extensive before and after gallery from previous customers, as well as detailed product information and how-to videos that explain the installation process. As with our call center, visitors can also order flooring samples. We have included endorsements by Bob Vila and Ty Pennington on the website to add credibility to our message. As part of our effort to distinguish the brand, we also maintain separate websites specifically for Bellawood ([www.bellawood.com](http://www.bellawood.com)) and the Ty Pennington collection ([www.tyscollection.com](http://www.tyscollection.com)), where customers can go to learn more about those product lines and which direct them to our website or our call center if they want to place an order.

Our Lumber Liquidators website was ranked as one of the top 50 retail websites of 2007 by an Internet industry source. Hitwise, a leading online analytics service, consistently ranks our website first relative to our specialty flooring competitors in overall sessions, page views and visit duration, based on their monthly analysis of several of our larger specialty competitors. Hitwise statistics also indicate that traffic is roughly split between men and women, with persons within the ages 25-34 and 35-44 each constituting approximately 25% of website visitors, and more than half of our visitors coming from households with annual incomes greater than \$60,000. In 2007, our website averaged more than 650,000 sessions per month through September 30, 2007, with approximately one out of every seven of our website visitors viewing the store locator page. In 2006, we began a concerted effort to collect the names and email addresses of customers who visit our website so as to better serve their needs and to assist us in marketing our products to them. We had collected approximately 500,000 mailable addresses as of September 30, 2007.

## ***Catalog and Other Mailings***

Our direct mail strategy focuses on regular contact with our customers and the targeting of prospective purchasers. We distribute our catalog, as well as other direct mailings, to key consumer and commercial segments around specific store locations. Copies of our catalog can also be obtained through our stores, our call center and our website. Our catalog supports in-store, call center and website sales, and approximately 70% of customers who purchased hardwood flooring from us during 2006 had requested a catalog from us. In February 2007, we conducted our first mass mailing of catalogs, in which we mailed approximately 1.5 million catalogs to former customers and others who had provided us with contact information. Response to that program led us to mail 1.5 million postcards in April, 1.5 million catalogs in May and another 1.5 million catalogs in September. In the first nine months of 2007, we also fulfilled 750,000 catalog requests either by handing catalogs out at a store or mailing them directly to the recipient's home. We believe these mailings contributed to an increase in store traffic and call center volume that led to more sales. We expect to continue expanding our catalog mailing efforts to prospective customers in markets where we have stores.



## **Table of Contents**

### **Customers**

We seek to appeal to customers who desire a high-quality product at an attractive value, and are willing to travel to less convenient locations to get it. We sell our products principally to existing homeowners, who represent about 80% of our customer count. Historically, these homeowners are in their mid-30 s or older, are well-educated and have been living in their homes for at least several years. Almost 50% of hardwood surface flooring purchases are made by households with incomes of \$70,000 or more. We have found that homeowners like various aspects of wood floors, including appearance and durability, ease of installation, renewability of resources and increasingly higher quality of engineered and laminate flooring. The majority of these customers hire a third-party installer to put in their flooring, with the remainder being do-it-yourself installers. Most of our other sales are to contractors, who are primarily small businesses that are either building a small number of new homes or have been hired by an owner to put in a new floor.

### **Customer Service and Sales Force**

We position ourselves as hardwood flooring experts and believe our high level of customer service reflects this positioning. Key elements of our service include providing consumers with useful product information and answering their hardwood flooring questions, ensuring product availability, following through on customer requests and selling high-quality products at an attractive value. Our store associates are familiar with all aspects of our store operations, and along with our call center staff, are trained to understand the characteristics and installation method for the broad range of hardwood flooring as well as guiding customers through the purchase process. Many of our staff have relevant industry experience, and we are currently developing a formal standardized training program for all of our store associates. We actively participate in local trade shows and home and garden shows, which we find to be an excellent opportunity to educate consumers about our products and distribute our catalogs and samples. Our website has a large frequently asked questions section, and potential hardwood flooring consumers can obtain live assistance through our online chat feature. Consumers can also access how-to videos and slideshows that provide detailed instructions on how to choose and install hardwood flooring.

While we generally do not provide or arrange flooring installation, nor do we generally recommend or endorse installers or installation companies, as a courtesy to our customers, each of our stores maintains a list of local third-party flooring installers that they may provide to customers. In August 2007, we began to work with a national installation company that will be either our exclusive or recommended installer at a number of stores we plan to open in 2007. Depending on the success of this program, we may expand it to other stores in the future. Even in these limited circumstances, however, choosing an installer remains the sole responsibility of the purchaser or homeowner, and we disclaim any liability for the work performed (or any damage caused) by any installer, including those on any list our stores may provide.

### **Marketing and Advertising**

We believe that our marketing and advertising supports our position as the hardwood flooring experts and as the specialty retailer that offers the broadest high-quality selection at everyday low prices. We have structured our marketing and advertising strategy to correspond with our understanding of the purchase cycle associated with hardwood flooring. Based on our market research, we believe that prospective customers generally do not buy on impulse. Instead, they invest time prior to their purchase to learn about hardwood flooring generally and to identify the correct hardwood flooring for their home. Accordingly, our marketing strategy emphasizes product credibility, brand awareness, customer education and direct selling.

## Table of Contents

We believe that we establish product credibility primarily through the strength of our product and the attractiveness of our pricing. We believe that we have achieved a reputation for quality and low prices, and that our proprietary brands are recognized for excellence by our customers. Our objective is to sell high-quality products at an attractive value, and we offer a large selection of hardwood flooring year-round at everyday low prices, ranging in quality from our premium Bellawood brand to our more economical brands. We try to avoid being perceived as a volume-driven discounter, so while our promotional cycle focuses on particular buying cycles, we generally try to hold our sales around events where we can create some excitement among customers. For example, we hold sales when we acquire bulk amounts of inexpensive inventory where we can pass along the savings, during three-day weekends when a customer has more time to consider (and possibly even install) a new flooring purchase, and during our annual odd lot sidewalk sale in April. In addition, as part of our efforts to optimize inventory levels, we implemented additional price discounts with respect to slower-moving inventory, primarily during the fourth quarter of 2006.

Our product credibility also benefits from celebrity endorsements and product placement opportunities, and we have long-term endorsement arrangements with respected and well-known home improvement celebrities Bob Vila and Ty Pennington. Bob Vila in particular has been associated specifically with our premium Bellawood proprietary brand for several years. Ty Pennington has endorsed both the Lumber Liquidators and Bellawood brands and has his own hardwood flooring collection, the Ty Pennington Collection. We also co-sponsor various television shows such as *Extreme Makeover: Home Edition* and HGTV's *Dream Home*, which use our products and enable potential customers to see both what our flooring will look like after installation and the relative ease with which it can be installed.

We increase brand awareness in a variety of ways, including both advertising and by demonstrating to customers our unique value proposition. We believe that our Lumber Liquidators brand is positioned based on three primary attributes—selection, price and service—while our Bellawood brand is known as a premium flooring brand within the industry. Over the last few years, we have invested significantly to build awareness and demand for all of our proprietary brands. To increase brand awareness, we conduct ad campaigns on both a national and local level using both traditional and new media. Our activities include:

buying ads in national and local publications, such as home and garden magazines and local newspapers;

using targeted television advertising on cable networks such as HGTV, TLC, DIY Network and A&E Network, co-sponsoring television shows like *This Old House* and securing product placement on television shows like those noted above;

advertising on syndicated radio programs such as *The Rush Limbaugh Show* and various programs on National Public Radio;

engaging in sports marketing by sponsoring the truck driven by Todd Bodine (the 2006 NASCAR Craftsman Truck Series champion) and engaging in marketing opportunities with Major League Baseball and the National Basketball Association;

engaging in banner advertising on the Internet, sponsoring links on well-known search engines, having storefronts with large e-tailers and having a large network of online affiliate partners; and

supporting charitable causes and local communities, including support for Habitat for Humanity, Tomorrow's Children Fund, the National Braille Press and Homes For Our Troops.

We believe our national advertising campaigns have been successful, and we expect to see greater returns on our investment in national advertising as more stores open near people who have already been

## **Table of Contents**

introduced to our brands. We expect to place a greater focus on local advertising to support targeted store growth while maintaining appropriate levels of national advertising. We believe that the percentage of our revenues devoted to marketing and advertising will decline as we continue to expand.

We strive to educate the customer in a variety of ways, including through our website, our catalog and our employees (both in the store and at external events, like trade shows). We also use a variety of mechanisms that directly support sales and focus on identifying new prospective customers and contacting known prospective customers to encourage them to make a purchase. Many of these require the potential customer to opt in, which we believe increases our response rate. For example, we send emails to our past customers and self-identified prospective customers, and we employ opt-in sweepstakes with major brands such as HGTV and TLC. We also distribute our catalog and other direct mailings throughout the year to key consumer and commercial segments targeted around specific store locations, and engage in telemarketing campaigns.

## **Suppliers**

We work directly with a select group of vendors and mills with whom we have cultivated long-standing relationships to ensure a consistent supply of high-quality product at the lowest prices. As part of ensuring the high-quality nature of our brands, we have developed demanding product standards. As we have grown, we believe our supplier relationships have strengthened, which we believe helps to ensure our access to a broad selection of products. Many suppliers have grown to support our business. We select suppliers based on a variety of factors, including their ability to supply products that meet industry grading standards and our specifications. As part of ensuring that they are meeting relevant standards, we inspect samples, make periodic site visits to our suppliers' mills and selectively inspect inbound shipments at our distribution center. Based on our historical experience, we believe that some of the mills that we use are among the best in their respective markets. We also support social and environmental responsibility among our supplier community, and the majority of our suppliers have entered into an environmental and social responsibility agreement with us. This agreement contains a code of conduct regarding our expectations concerning environmental, labor and health and safety matters. We encourage the use of renewable resources, and generally prefer to use suppliers that operate in areas where the harvest rate is slower than tree planting and growth rates.

We currently purchase products from approximately 90 vendors. We primarily purchase flooring directly from mills and trading companies. In 2006, 68% of our hardwood merchandise was purchased directly from mills, 31% was purchased from trading companies and 1% of our product was purchased through buying agents. Trading companies contract with mills to make products for us, and handle certain shipping and customs matters. In 2006, one of our suppliers, Sequoia Floorings, accounted for approximately 14% of our purchases, and acted as agent for another of our suppliers that accounted for another 7% of our purchases. Including those companies, our top 10 suppliers account for approximately 63% of our supply purchases in 2006. We believe that we are one of the largest customers for most of our largest suppliers, which we believe enables us to obtain better prices in some circumstances.

We do not have long-term contracts with most of our suppliers, as we believe is standard in our industry, but we believe we have stable long-term historical relationships with the majority of mills with whom we do business. We generally purchase product on an order-by-order basis, and write orders for delivery in 90 to 180 days. We also have one long-term purchase agreement with a trading and import company that we entered into in July 2006. Pursuant to the terms of that agreement, we are required to order a specified minimum amount of product each year, totaling approximately 27 million square feet of product (representing less than 5% of our estimated purchasing needs) over the four-year period of the agreement. The agreement provides for a set menu of products, including prices and specifications, from which we can pick in placing our orders. The agreement also provides for a detailed process by which either party can request a change in prices or specifications, or add or delete products from the menu. Certain disputes have arisen between the parties primarily with regard to product quality, unit price changes and delivery and payment obligations. We are not currently receiving any product under the

## **Table of Contents**

agreement and we intend to seek payment for our cover costs relating to purchase orders that were not delivered. The products we ordered from the vendor that are not being delivered are available from other suppliers and the cover costs are expected to be immaterial.

Overseas suppliers deliver our product to us by sea, usually requiring between 21 and 35 days from port to port. These products are delivered to a U.S. port of entry, most frequently Norfolk, Virginia, after which the majority is shipped to our Toano distribution facility for finishing (when required) and distribution to our stores. The balance is shipped directly from the port of entry to our stores. Products supplied by our North American suppliers are generally delivered to our Toano facility or our stores by truck. Our Toano facility is strategically located near the international shipping port in Norfolk, Virginia and major east-west and north-south interstate highways. In 2006, approximately 30% of our product was sourced from Asia, approximately 24% was sourced from South America, approximately 35% was sourced from North America and 11% was sourced from other locations. All of our foreign purchases are negotiated and paid for in U.S. dollars.

Although we maintain strong relationships with our suppliers, we believe that opportunities exist to improve purchasing terms in the future. In evaluating suppliers, one of the factors we consider is their access to new or hard-to-find species of wood, so that we can continue to expand our range of exotic hardwood products. We also seek out new mills that can meet our standards, and we work with them to evaluate new hardwood species and new technologies that may allow us to expand or improve our operations. We continually seek out new suppliers to ensure that we have sufficient product flow to support our current operations and expected growth. We believe that alternative and competitive suppliers are available for most of our products.

## **Finishing**

We finish more than 20 million square feet of prefinished hardwood flooring annually at our state-of-the-art finishing facility in Toano. This includes approximately 70% of all Bellawood products, the balance of which we obtain from qualified prefinishing suppliers in both North and South America. We also finish small quantities of certain of our other products at that facility. The Toano finishing facility sources both domestic and exotic unfinished flooring from more than 20 mills, trading companies and buying agents located in North and South America, Asia and Australia. We currently operate one finishing line at Toano and we have the space to construct a second finishing line in that facility. We continually invest in improving our process controls and product quality, and we believe that our existing finishing infrastructure at our Toano facility can support our planned growth over at least the next three years. We believe the incremental investment to fund a second finishing line at our Toano facility will be limited and can be funded through cash flow from operations.

At our Toano facility, we prefinish the hardwood flooring to produce a product that has one of the highest scuff resistant finishes in the industry as measured by the Taber Abrasion Test, an abrasion testing method designed to measure the abrasion resistance of protective floor finishes. The prefinishing process involves several steps. We begin the process by sanding the unfinished hardwood to ensure that it has uniform thickness and optimal smoothness. We then apply multiple coats of natural stains and urethane-based sealers to enhance grain appearance and provide excellent abrasion resistance and toughness. Each coat is cured to ensure proper adhesiveness to the hardwood, and the wood is scuffed with denibber brushes between coats to ensure smoothness. Finally, we apply a topcoat, which provides scratch and stain resistance, further enhances abrasion resistance and controls the final gloss or sheen of the hardwood flooring. The topcoat is then cured and cooled, and the prefinished hardwood is graded and boxed.

We have adopted sophisticated quality assurance policies and techniques, which are based on national and international standards where appropriate. These standards specify requirements for flooring products, sampling techniques and other quality-related activities, and are published by organizations

## **Table of Contents**

such as the National Wood Flooring Association, the National Oak Flooring Manufacturers Association and the International Organization for Standardization.

Throughout the prefinishing process, we perform numerous tests and visual inspections to verify that the flooring complies to our specifications, that we are maintaining effective control over the finishing process and that the final prefinished hardwood flooring meets our requirements. In developing these policies and techniques, we emphasize defect prevention, minimizing variations in our products, decreased waste and workplace safety. For example, samples of each of our products undergo Taber Abrasion Testing. As part of the testing process, flooring is secured to a turntable that is a weighted wheel covered in sandpaper. The turntable is rotated, causing the sandpaper to wear against the finish. Each full revolution is counted as a Taber cycle, and the number of rotations that it takes the sand paper to get through the finish becomes the Taber rating for that finish.

## **Distribution, Order Fulfillment and Inventory Management**

We operate a single distribution center located in Toano, Virginia. We warehouse our products at that facility before shipping them to our stores by truck, and approximately 85% of our merchandise passes through this facility before we move it to our stores. It generally takes between two to five days for a shipment to reach our stores, and each store receives an average of 1.4 shipments per week. In some cases, our suppliers deliver products directly to our stores. We believe that our existing distribution infrastructure at our Toano facility can support our planned growth over at least the next three years. We continually monitor our operations to identify opportunities to improve efficiencies, and are currently working with a consultant to improve the efficiency of our operations and plan for future growth.

In the first quarter of 2007, we upgraded our corporate network with high-speed dedicated lines capable of carrying both voice and data communications. At this time all of our stores were rewired for voice and data. Voice communications are now carried over a scalable Internet-based network. Before the end of 2007, we plan to implement a new point-of-sale system in all of our stores. This touch screen system provides for real-time tracking of inventory and sales information. We believe that our updated inventory management and communications systems will allow for improved forecasting, more efficient inventory management, rapid stock replenishment and concise merchandise planning. We believe that these systems will give us substantial flexibility as we grow.

## **Competition**

We are the largest specialty retailer of hardwood flooring in the United States, and compete in a hardwood flooring market that is highly fragmented. We compete on the basis of price, quality, selection and availability of hardwood flooring we offer our customers, as well as the level of customer service we can provide. Our competitive position is also influenced by the availability, quality and cost of merchandise, labor costs, finishing, distribution and sales efficiencies and our productivity compared to that of our competitors. The market includes both national and regional home improvement chains which specialize in the lower-end, higher-volume flooring market and offer a wide range of home improvement products other than flooring. We also compete against smaller national specialty flooring chains, some of which have an Internet presence, and a large number of local and regional independent flooring retailers, including a large number of privately-owned single-site enterprises.

We estimate, based on internal market research, that our share of the hardwood flooring retail market was approximately 6% in 2006, up from approximately 4% in 2005. We believe that we compete effectively against the large national chains by offering competitive prices, higher-quality hardwood flooring products, a broader product assortment, a shorter delivery time, and better customer service by virtue of our more knowledgeable sales staff and single-product focus. In addition, we believe that our largest competitors with Internet operations focus to a greater extent on the lower-priced segment of the

**Table of Contents**

hardwood flooring market, particularly engineered, bamboo and laminate flooring. The remainder of the hardwood flooring market is dominated by small local independent retailers that usually sell carpet and tile in addition to hardwood flooring. Most of these retailers purchase their hardwood flooring from domestic manufacturers or distributors, and typically do not stock hardwood flooring, but order it only when the customer makes a purchase. As a result, we believe it takes these retailers longer than us to deliver their product to customers, and their prices tend to be higher than ours.

We also compete against companies that sell other types of floor coverings, such as carpet, vinyl sheet and tile, ceramic tile, natural stone and others.

**Employees**

As of December 31, 2006, we had 490 employees, 96% of whom were full-time and none of whom was represented by a union. Of these employees, 57% work in our stores, 22% work in corporate or similar functions (including our call center employees) and 21% work in our finishing and distribution operations. As of September 30, 2007, we had 651 employees, of whom 64% work in our stores, 17% work in corporate or similar functions and 19% work in our finishing and distribution operations. We believe that we have good relations with our employees.

**Properties**

As of September 30, 2007, we operated 111 stores located in 42 states. Our stores average approximately 6,400 square feet, of which an average of 800 square feet is dedicated to the showroom and the remainder used as a warehouse. As of September 30, 2007, we had opened 20 new stores and had signed leases for seven additional stores (which, since they are not yet operational, are not included in the table below) in 2007. Our Toano, Virginia finishing and distribution facility has 307,784 square feet, of which approximately 32,000 square feet are office space, and is located in on a 74-acre plot. We currently operate one finishing line at Toano, and we have the space to construct a second finishing line in that facility.

The table below sets forth the locations (alphabetically by state) of our stores in operation as of September 30, 2007.

<b>State</b>	<b>Stores</b>	<b>State</b>	<b>Stores</b>	<b>State</b>	<b>Stores</b>	<b>State</b>	<b>Stores</b>
Alabama	1	Indiana	2	Missouri	1	Oregon	1
Arizona	2	Iowa	1	Nebraska	1	Pennsylvania	4
Arkansas	1	Kansas	1	Nevada	2	S. Carolina	2
California	9	Kentucky	1	New Hampshire	2	Tennessee	3
Colorado	2	Louisiana	2	New Jersey	3	Texas	9
Connecticut	2	Maine	1	New Mexico	1	Utah	1
Delaware	1	Maryland	2	New York	6	Virginia	6
Florida	11	Massachusetts	4	N. Carolina	2	Washington	3
Georgia	2	Michigan	3	Ohio	4	W. Virginia	1
Idaho	1	Minnesota	2	Oklahoma	2	Wisconsin	3
Illinois	2	Mississippi	1				

We lease all of our stores and our Toano finishing and distribution facility. Our store leases generally have an initial operating lease term of five years and most provide options to renew for specified periods of time. A majority of our leases provide for fixed monthly or annual rentals. Certain of our leases include provisions for escalating rent, generally at fixed increases on predetermined dates. Many of our leases require us to pay taxes, insurance and common area maintenance expenses

## **Table of Contents**

associated with the properties. The initial operating lease term for our Toano facility runs through December 31, 2019, with an option to renew for an additional 15-year term. Our Toano lease provides for fixed monthly rent with an annual increase of 3.0%, and it requires that we pay real estate taxes associated with the property, carry certain insurance and maintain the property in good condition and repair.

We currently lease 23 of our store locations and our Toano facility, which includes a store location, from ANO LLC, a company that is wholly owned by Tom Sullivan, our founder and the chairman of our board of directors. Tom is also the sole owner of DORA Real Estate Company, LLC and Wood on Wood Road, Inc., and has a 50% membership interest in BMT Holdings, LLC, and we lease one store location from each of these entities. See Certain Relationships and Related Party Transactions.

## **Intellectual Property and Trademarks**

We have a number of marks registered in the United States, including Lumber Liquidators®, Bellawood®, 1-800-FLOORING®, Dura-Wood®, Blutec®, Quickclick®, Virginia Mill Works Co. Hand Scraped and Distressed Floors®, Morning Star Bamboo Flooring® and Dream Home Laminate Floors® and the Lumber Liquidators design mark, and have applied to register a number of other trademarks, including Builder's Pride®, Schön Engineered Floors® and other product line names. We have also registered certain marks in jurisdictions outside the United States, including the European Union, Canada, Australia and Japan, and have registration applications pending in several other jurisdictions. We regard our intellectual property as having significant value and these names are an important factor in the marketing of our brands. We are not aware of any facts that could be expected to have a material adverse effect on our intellectual property.

## **Government Regulation**

We are subject to extensive and varied federal, state and local government regulation, including regulations relating to employment, public health and safety, zoning and fire codes. We operate each of our stores and finishing facility and distribution center in accordance with standards and procedures designed to comply with applicable codes and regulations.

Our operations and properties are also subject to federal, state and local laws and regulations relating to the use, storage, handling, generation, transportation, treatment, emission, release, discharge and disposal of hazardous materials, substances and wastes and relating to the investigation and clean up of contaminated properties, including off-site disposal locations. We do not incur significant costs complying with environmental laws and regulations. However, we could be subject to material environmental costs, liabilities or claims in the future, especially in the event of changes in existing laws and regulations or in their interpretation.

Our suppliers are also subject to the laws and regulations of their home countries, including in particular laws regulating forestry and the environment. We consult with our suppliers as appropriate to ensure that they are in compliance with applicable home country laws. We also support social and environmental responsibility among our supplier community, and the majority of our major suppliers have entered into an environmental and social responsibility agreement with us. This agreement contains a code of conduct regarding our expectations concerning environmental, labor and health and safety matters, which includes among its guidelines an understanding that our suppliers must comply with the laws, rules and regulations of the countries in which they operate.

**Table of Contents**

**Legal Proceedings**

We are involved in a claim brought by Dr. Clifford Wayne Bassett in the U.S. District Court for the Southern District of New York against us, E.W. Scripps Company ( Scripps ) and others, in connection with an article we purchased from Scripps, describing the benefits of hardwood flooring in relation to other types of flooring. The article contained a quote by Dr. Bassett, an allergist, who claims the quote was unauthorized. Dr. Bassett has asserted damages in excess of \$10 million. The matter is in the early stages of litigation and, while there is a reasonable possibility that a material loss may be incurred, we cannot estimate the loss to us, if any, at this time. We intend to defend vigorously against this claim and, to the extent warranted, to seek contribution or indemnification from other parties.

In July 2007, a former senior executive officer filed a demand for arbitration in connection with his resignation of employment in May 2006. That executive alleges that he terminated his employment for good reason, as defined in his employment agreement and our warrant plan, based on an allegedly substantial reduction in his responsibilities. In his demand for arbitration, the former senior executive contends that we breached our obligations to him upon his resignation of employment. He is seeking damages of approximately \$0.7 million (plus the value of certain other specified benefits), as well as a declaration that he has owned 1% of the company since he terminated his employment. An arbitration hearing was held on October 1-2, 2007. The parties will be afforded the opportunity to submit post-arbitration briefs and additional testimony and evidence may be presented. While there is a reasonable possibility that a material loss may be incurred, we cannot estimate the loss to us, if any, at this time. We intend to defend vigorously against this claim.

In addition, we are involved in various claims and legal actions in the ordinary course of business. We do not believe that the ultimate resolution of these actions will have a material adverse effect on our financial position, results of operations, liquidity or capital resources. However, a significant increase in the number of these claims or an increase in amounts owing under successful claims could materially and adversely affect our business, financial condition, results of operations and cash flows.



**Table of Contents****MANAGEMENT****Executive Officers and Directors**

The following table sets forth information about our executive officers and directors, including their ages as of September 30, 2007.

<b>Name</b>	<b>Age</b>	<b>Position</b>
Thomas D. Sullivan	48	Chairman of the board of directors; Founder (1)
Jeffrey W. Griffiths.	56	President and chief executive officer; Director (2)
Douglas T. Moore	51	Director (1)
John M. Presley	47	Director (1)
Martin F. Roper	44	Director (1)
Richard D. Tadler	50	Director (1)
Macon F. Brock, Jr.	65	Director nominee (3)
Daniel E. Terrell	43	Chief financial officer
E. Livingston B. Haskell	35	Secretary; General corporate counsel
Rick A. Boucher	50	Senior vice president, supply chain
Robert M. Morrison	51	Senior vice president, store operations
Marco Q. Pescara	42	Senior vice president, direct marketing and advertising
Andrew P. Shulklapper	45	Senior vice president, merchandising
Kenneth M. Strohschein	36	Senior vice president, information technology
H. Franklin Marcus, Jr.	62	Vice president, finance; Treasurer
Tyler C. Greenan	38	Vice president, store operations

(1) The parties to the stockholders agreement described below under Certain Relationships and Related Party Transactions agreed to elect to our board one individual nominated by TA Associates Funds, two individuals nominated by Mr. Sullivan and two individuals nominated by Mr. Sullivan who are deemed acceptable by TA Associates Funds. TA Associates Funds selected Mr. Tadler and Mr. Sullivan selected himself among the initial nominees. Messrs. Moore, Presley and Roper were subsequently nominated and elected to the board effective April 2006.

(2) Mr. Griffiths serves on our board pursuant to his employment agreement with us.

(3) Mr. Brock has been nominated to serve on the board, effective the day after this offering closes.

**Thomas D. Sullivan** is our founder and has been the chairman of our board of directors since our inception in 1994. Prior to September 2006, Mr. Sullivan also served as president and chief executive officer since our incorporation in 1994. Mr. Sullivan serves on the board of directors of Dillon Technologies, LLC and several other privately held companies.

**Jeffrey W. Griffiths** has been the president and chief executive officer of Lumber Liquidators since September 2006, and a director of Lumber Liquidators since October 2006. Mr. Griffiths was previously the president and chief executive officer of video game retailer Electronics Boutique Holdings Corp. ( EB ) from 2001 through 2005, when EB merged with GameStop Corp. Mr. Griffiths' career at EB spanned more than 20 years. He served as vice president and senior vice president of merchandising, marketing and distribution for EB from 1987 to 1996 and from 1996 to 2001, respectively. Mr. Griffiths also served as a director of EB from 2001 to 2005 and of Game PLC, formerly Electronics Boutique PLC, from 1995 to 1997. Mr. Griffiths holds a B.A. in history from Albright College and an M.B.A. from Temple University. He serves on the board of directors of THQ, Inc., on the board of trustees of Albright College and the board of directors of the Philadelphia Academies Inc.

**Douglas T. Moore** has been a director of Lumber Liquidators since April 2006. Mr. Moore currently serves as senior vice president, hardlines merchandising for Sears Holdings Corporation in Hoffman

**Table of Contents**

Estates, Illinois. In this capacity, he is the chief merchant for the appliance, lawn and garden, tools and home electronics businesses for Sears and KMart. Mr. Moore served for 17 years as a senior executive of Circuit City Stores, Inc., with his last position as executive vice president, chief merchandising officer. Mr. Moore has also held operational and consumer marketing positions at AMF Bowling, Inc., A.H. Robins Company, Inc. and the Carnation Company. He received his undergraduate degree and M.B.A. from the University of Virginia.

**John M. Presley** has been a director of Lumber Liquidators since April 2006. In May 2006, Mr. Presley joined Fifth Third Bancorp in a strategic initiative post, where he is responsible for executing market banking strategies in existing and emerging markets. He previously served as chief financial officer for Marshall & Ilsley Corp. from 2004 to 2006, and was chief financial officer of National Commerce Financial Corp. in Memphis, Tennessee, and president and chief executive officer of First Market Bank in Richmond, Virginia. Mr. Presley holds a B.A. in economics and business administration from Rhodes College.

**Martin F. Roper** has been a director of Lumber Liquidators since April 2006. Mr. Roper is the president and chief executive officer of The Boston Beer Company, Inc., where he has worked since 1994 and has been a director since 1999. Prior to assuming that position in January 2001, he had served as the president and chief operating officer of that company since December 1999. Mr. Roper holds a B.A. in engineering and M.A. in engineering in manufacturing technology from Cambridge University and an M.B.A. from Harvard Business School. He serves on the board of directors of The Boston Beer Company, Inc.

**Richard D. Tadler** has been a director of Lumber Liquidators since December 2004. Mr. Tadler is a managing director of TA Associates, Inc. He has been associated with TA Associates, Inc. since 1987, specializing in medical and specialty service businesses. Mr. Tadler holds a B.S. in finance from the McIntire School of Commerce at the University of Virginia and an M.B.A. from the Wharton School of Finance. He is currently a director of several privately held companies and non-profit organizations.

**Daniel E. Terrell** has been the chief financial officer of Lumber Liquidators since October 2006. Prior to assuming this position, Mr. Terrell served as our controller from November 2004. Mr. Terrell was previously the vice president, controller & credit of Peebles Inc., a specialty apparel retailer that he joined in 1990 and where he continued to work after it was acquired in 2003 by Stage Stores, Inc. Before joining Peebles, Mr. Terrell worked for Ernst & Young. Mr. Terrell holds a B.S. in accounting from Virginia Tech.

**E. Livingston B. Haskell** has been the secretary and general corporate counsel of Lumber Liquidators since July 2006. Prior to assuming this position, Mr. Haskell was a partner at Williams Mullen and, before February 2006, was an associate at that firm. Mr. Haskell holds a B.S. in finance and marketing from the McIntire School of Commerce at the University of Virginia and a J.D. from Washington and Lee University.

**Rick A. Boucher** has been senior vice president, supply chain of Lumber Liquidators since July 2007. Prior to assuming this position, Mr. Boucher served more than 22 years with Cadbury Schweppes PLC as the North American vice president of logistics and distribution. Mr. Boucher holds a B.D. in business administration from Niagara College.

**Robert M. Morrison** has been the senior vice president, store operations of Lumber Liquidators since January 2006. Prior to assuming this position, Mr. Morrison worked at and was part-owner of Morrison/Fleming Solutions from May 2005. Mr. Morrison was also president of Artistic Tile, Inc. from 2004 to 2005 and senior vice president and chief operating officer of Waterworks Inc. from 1999 to 2004. Mr. Morrison holds a B.S. in geology from Michigan State University.

**Table of Contents**

**Marco Q. Pescara** has been the senior vice president, direct marketing and advertising of Lumber Liquidators since April 2006. Prior to assuming this position, Mr. Pescara served for more than five years as the vice president of direct response and marketing integration at Hickory Farms, Inc. Mr. Pescara holds a B.S. from the University of Toledo, an M.S. from Boston University and an M.B.A. from the University of Pittsburgh.

**Andrew P. Shulklapper** has been the senior vice president, merchandising of Lumber Liquidators since February 2007. Prior to assuming this position, Mr. Shulklapper was the division merchandise manager, consumer electronics for Sears Holdings Corporation from 2004 until 2007 and vice president, global market research for Displaysearch from 2003 to 2004. He also worked at Circuit City Stores, Inc. for twelve years, and the last position he held there was division merchandise manager for consumer electronics. Mr. Shulklapper holds a B.A. in economics from the University of Vermont.

**Kenneth M. Strohschein** has been the senior vice president, information technology of Lumber Liquidators since February 2006. Prior to assuming this position, Mr. Strohschein worked for Hickory Farms, Inc. from 2003, where he served as vice president of management information systems, chief information officer of that company from 2004 to 2006. Mr. Strohschein also worked for ten years at Busch's Incorporated, a supermarket chain where, among other positions, he served as director of information technology for eight years. Mr. Strohschein holds a B.S. in management information systems from Kennedy-Western University.

**H. Franklin Marcus, Jr.** has been the vice president, finance and treasurer of Lumber Liquidators since October 2006. Prior to assuming this position, Mr. Marcus served as our chief financial officer from 2001 to 2006 and our secretary from 2004 to 2006. Mr. Marcus holds a B.S. in accounting from the McIntire School of Commerce at the University of Virginia.

**Tyler C. Greenan** has been the vice president, store operations of Lumber Liquidators since 2003. Prior to assuming this position, Mr. Greenan served as a regional manager and our vice president of store operations from 1998. Mr. Greenan holds a B.A. from the University of Miami.

Set forth below is a brief description of Mr. Macon F. Brock, Jr., who we expect will become a director effective the day after this offering closes:

**Macon F. Brock, Jr.** has been nominated to serve as a director, effective the day after this offering closes. Mr. Brock is a founder of Dollar Tree Stores, Inc. He served as the President of Dollar Tree from 1986 until 2001 and as Chief Executive Officer from 1993 until 2003. He has been a director of Dollar Tree since 1986 and Chairman of the Board since 2001. Until 1991, Mr. Brock was an officer and director of K&K Toys, Inc. Mr. Brock is Chairman of Randolph-Macon College. Mr. Brock also serves on the boards of directors of several smaller privately held companies and non-profit organizations. Mr. Brock earned his B.A. from Randolph-Macon College and served as a Captain in the U.S. Marine Corps. He was a special agent for U.S. Naval Intelligence before entering the retail business.

## **Table of Contents**

### **Board of Directors**

#### ***Board Structure***

We currently have six directors. We have nominated Macon Brock to serve on the board, effective the day after this offering closes. All members of the board are elected annually. In connection with this offering, we will change the structure of the board and the method of electing directors. The board will be divided into three classes, as nearly equal in number as possible, serving staggered terms. About one-third of the board will be elected annually. See Description of Capital Stock Certain Certificate of Incorporation and Bylaw Provisions. Our board has determined all of our directors other than Messrs. Sullivan, Griffiths and Tadler (for purposes of the audit committee only) meet the independence requirements of the New York Stock Exchange and the federal securities laws.

#### ***Board Committees***

Prior to this offering, our board of directors established standing committees in connection with the discharge of its responsibilities. These committees include an audit committee, a compensation committee and a nominating and governance committee. The board of directors will also establish such other committees as it deems appropriate, in accordance with applicable law and regulations and our certificate of incorporation and bylaws.

***Audit Committee.*** Prior to this offering, our board of directors established an audit committee, consisting of Messrs. Presley (chair), Moore and Roper, to assist our board in overseeing the preparation of our financial statements, the independent registered public accounting firm's qualifications and independence, the performance of our internal audit function and independent registered public accounting firm and our compliance with legal and regulatory requirements. Within a year of this offering, all of the members of the audit committee will be independent, as determined in accordance with the rules of the New York Stock Exchange and any relevant federal securities laws and regulations. Immediately following the offering, we expect that at least one member of the committee will be independent, as permitted by the relevant transition rules.

***Compensation Committee.*** Prior to this offering, our board of directors established a compensation committee, consisting of Messrs. Roper (chair), Tadler and Brock. Within a year of this offering, all of the members of the compensation committee will be independent, as determined in accordance with the terms of the New York Stock Exchange and any relevant federal securities laws and regulations. Immediately following the offering, we expect that at least one member of the committee will be independent, as permitted by the relevant transition rules. The compensation committee will have overall responsibility for evaluating and approving our executive officer incentive compensation, benefit, severance, equity-based or other compensation plans, policies and programs. The compensation committee will also produce an annual report on executive compensation for inclusion in our proxy statement.

***Nominating and Governance Committee.*** Prior to this offering, our board of directors established a nominating and governance committee, consisting of Messrs. Moore (chair), Presley and Brock. Within a year of this offering, all of the members of the nominating and governance committee will be independent, as determined in accordance with the rules of the New York Stock Exchange and any relevant federal securities laws and regulations. Immediately following the offering, we expect that at least one member of the committee will be independent, as permitted by the relevant transition rules. The nominating and governance committee will assist our board of directors in implementing sound corporate governance principles and practices. Our nominating and governance committee will identify individuals qualified to become board members and recommend to our board of directors the director nominees for the next annual meeting of shareholders. It will also review the qualifications and independence of the members of our board of directors and its various committees on a regular basis and make any

## **Table of Contents**

recommendations the committee members may deem appropriate from time to time concerning any recommended changes in the composition of our board.

### **Limitation of Liability and Indemnification**

Our certificate of incorporation and bylaws will limit the liability of directors to the maximum extent permitted by Delaware law. Specifically, a director will not be personally liable for monetary damages for breach of fiduciary duty as a director, except liability for:

any breach of the director's duty of loyalty to us or our shareholders;

acts of omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

unlawful payments of dividends or unlawful stock repurchases or redemptions; or

any transaction from which the director derived an improper personal benefit.

Our bylaws will provide that we will indemnify our directors and officers and may indemnify our employees and other agents to the fullest extent permitted by law. We believe that indemnification under our bylaws will cover at least negligence and gross negligence on the part of indemnified parties. Our bylaws will also provide that we will advance expenses incurred by a director or officer in advance of the final disposition of any action or proceeding, and we may advance expenses incurred by our employees or other agents in advance of the final disposition of any action or proceeding. Our bylaws will also permit us to secure insurance on behalf of any officer, director, employee or other agent for any liability arising out of his or her actions in his or her capacity as an officer, director, employee or other agent. We have in the past and may in the future enter into agreements to indemnify our directors, executive officers and other employees as determined by the board of directors. These agreements will provide for the indemnification of directors and officers to the fullest extent permitted by Delaware law, whether or not expressly provided for in our bylaws, and govern the process by which claims for indemnification are considered. We believe that these bylaw provisions and indemnification agreements are necessary to attract and retain the services of highly qualified persons as directors and officers.

The limited liability and indemnification provisions in our certificate of incorporation, bylaws and indemnification agreements may discourage shareholders from bringing a lawsuit against our directors for breach of their fiduciary duty and may reduce the likelihood of derivative litigation against our directors and officers, even though a derivative action, if successful, might otherwise benefit us and our shareholders. A shareholder's investment in us may be adversely affected to the extent we pay the costs of settlement or damage awards against our directors and officers under these indemnification provisions.

There is no pending litigation or proceeding involving any director, officer or employee where indemnification is sought, nor are we aware of any threatened litigation that may result in indemnification claims.

Insofar as indemnification for liabilities arising under the Securities Act may be permitted for directors, officers and controlling persons of us under the foregoing provisions or otherwise, we have been informed that, in the opinion of the SEC, such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable.

### **Compensation Committee Interlocks and Insider Participation**

None of the members of our compensation committee will be or have ever been an officer or employee of us. None of our executive officers serves or has served as a member of the board of

## **Table of Contents**

directors, compensation committee or other board committee performing equivalent functions of any entity that has one or more executive officers serving as one of our directors or on our compensation committee.

### **Director Compensation**

For 2006, directors who are also our employees, as well as Mr. Tadler, did not receive compensation for their service on our board of directors or any board committee. Each of our other non-employee directors received an annual retainer fee of \$15,000, payable quarterly in increments of \$3,750, beginning in the quarter in which they were elected. The three non-employee directors who received such compensation (Martin Roper, Douglas Moore and John Presley) were elected effective April 26, 2006, so each received an annual retainer fee of \$11,250. This retainer fee covers annual services, including participation in up to six board meetings. If Messrs. Roper, Moore and Presley attended more than six meetings during the year, they would have been entitled to receive meeting fees of \$2,500 per meeting attended in person or \$1,000 per meeting attended by telephone. Each of Messrs. Roper, Moore and Presley also received options to purchase 26,385 shares of our stock at an exercise price of \$7.58 per share (which, based upon management's estimate, was the fair market value of a share of our stock on the date the options were granted). Directors have also been reimbursed for expenses incurred in connection with their service as directors, including travel expenses for meeting attendance.

Upon consummation of this offering, directors who are also our employees will continue to receive no compensation for their service on our board of directors or any board committee. We expect to pay all of our non-employee directors (including Mr. Tadler) annual retainer fees and additional fees for attendance at board meetings in excess of six per year, and making annual option grants to our non-employee directors under our 2007 Plan, in each case in the amounts set annually by the board of directors. While the final amounts have not yet been determined by the board, we currently expect that each non-employee director will receive an annual cash retainer of \$25,000 and an annual grant of restricted stock units with a one-year vesting period, in an amount to be set based upon the closing price of our common stock at the end of the day on which we hold our annual shareholder's meeting, but not to exceed a value of approximately \$65,000. We expect that directors will be given the opportunity to take the cash portion of their retainer in company stock. Annual retainers are expected to be paid to the chairperson of each committee of the board of directors as follows: \$15,000 for the audit committee chairperson, \$7,500 for the compensation committee chairperson and \$5,000 for the nominating/governance committee chairperson. Annual retainers are also expected to be paid to committee members as follows: \$7,500 for the audit committee, \$3,750 for the compensation committee and \$2,500 for the nominating/governance committee. Directors will also be reimbursed for expenses incurred in connection with their service as directors, including travel expenses for meeting attendance. We intend to continue to reimburse promptly all non-employee directors for reasonable expenses incurred to attend meetings of our board of directors or board committees. Other than as described above, we do not expect to provide any of our directors with any other compensation or perquisites.

**Table of Contents**

The following table sets forth compensation paid to our directors in their capacities as such in the fiscal year ended December 31, 2006.

Name	Fees Earned or Paid in Cash (\$)	Stock Awards (\$)	Option Awards \$(1)	Non-Equity Incentive Plan Compen- sation (\$)	Change in		Total (\$)
					Pension Value and Nonqualified Deferred Compensation Earnings	All Other Compen- sation (\$)	
Thomas D. Sullivan(2)							
Jeffrey W. Griffiths(2)							
Richard D. Tadler							
Martin F. Roper	\$ 11,250		\$ 12,335				\$ 23,585
Douglas T. Moore	\$ 11,250		\$ 12,335				\$ 23,585
John M. Presley	\$ 11,250		\$ 12,335				\$ 23,585

(1) These options were granted under our 2006 Equity Plan for Non-Employee Directors and vest 25% on each of the first four anniversaries of grant, subject to acceleration in certain circumstances. The options have a strike price of \$7.58 per share and expire July 13, 2016. Figures shown represent the dollar amounts of compensation cost recognized by us in 2006, in accordance with SFAS 123 (R), of director stock options. For a discussion of the assumptions relating to these valuations, see Summary of Significant Accounting Policies Stock-Based Compensation in Note 1 to our financial statements.

(2) We paid compensation to Messrs. Sullivan and Griffiths in their capacities as executive officers as detailed below.

**2006 Equity Plan for Non-Employee Directors**

Our 2006 Equity Plan for Non-Employee Directors, as amended effective October 18, 2006, provides for the grant of non-qualified stock options and restricted and unrestricted stock awards to non-employee directors. 200,000 shares are reserved for issuance under the plan, subject to adjustment to reflect changes in our stock due to corporate events such as reorganization, recapitalization, stock dividends, stock splits and reverse stock splits. The plan is administered by the board or a committee of the board composed of at least two directors (the 2006 Plan Committee). Fair market value is determined by the 2006 Plan Committee unless the stock is traded on a national securities exchange or automated quotation system, in which case the fair market value on any day will be the closing price reported on that day (except that on the first day on which the trading prices are so reported, the fair market value will be the price to the public stated in the final prospectus relating to our initial public offering). Options and restricted stock granted under the plan are non-transferable. At the request of a grantee and with the consent of the 2006 Plan Committee, grantees may receive a portion of cash compensation otherwise due to them in the form of unrestricted stock awards under the plan.

In the event of a 2006 Plan Sale Event (which includes our liquidation or dissolution, merger, sale of all or substantially all of our assets or a majority of our stock to an unrelated person, or any other transaction that results in a change ownership of a majority of voting control of us), the plan and all outstanding options terminate unless the parties to the transaction arrange to assume or continue the options following completion of the transaction. In the event of such a termination, holders will be given a specified period of time before the transaction to exercise outstanding options that are then exercisable or will become exercisable as of the effective time of the 2006 Plan Sale Event (subject to consummation of such 2006 Plan Sale Event). The board may amend or terminate the plan at any time, and the 2006 Plan Committee may amend or cancel any outstanding award, provided such action does not adversely affect the rights of the holder of any outstanding award without his or her consent.

Option grant agreements issued under the plan generally provide that options vest in four equal installments on the first four anniversaries of the applicable grant date, provided that (a) upon the occurrence of an initial public offering, vesting of the option will be accelerated by one year and (b) upon

## **Table of Contents**

the occurrence of a 2006 Plan Sale Event, (i) 50% of the unvested portion of the option will vest and (ii) if the option is assumed or continued by us or any successor of us, the option will vest in full upon a termination of the optionee's service as a director within 18 months of such 2006 Plan Sale Event. Following a termination of the optionee's service as a director, the agreements generally provide that the option will remain exercisable (to the extent vested) for 12 months (in the case of the optionee's death or disability) or 90 days (in the case of termination of service as a director for any other reason). Shares acquired upon exercise of the option may be transferred only upon the optionee's death to his or her representatives, or to or for the benefit of certain family members, provided that we have a right of first refusal to purchase the shares prior to any such transfer. We also have the right to repurchase shares acquired through exercise of the option upon any termination of the optionee's service as a director or upon the optionee's bankruptcy, and have drag along rights in the event of certain events constituting a change in control of us. The transfer restrictions and drag along rights under the agreements terminate upon the occurrence of an initial public offering or 2006 Plan Sale Event.

### ***2007 Plan***

We expect to make future grants of stock options, restricted and unrestricted stock awards and other equity-based compensation to non-employee directors under our 2007 Plan. See [Lumber Liquidators, Inc. 2007 Equity Compensation Plan](#) below.

### **Compensation Discussion and Analysis**

Our overall compensation philosophy is to maintain effective compensation programs that are as simple and flexible as possible, and permit us to make responsive adjustments to changing market conditions. We strive to provide our executive officers with compensation that is competitive within the industry and the executives' geographic location in order to successfully attract and retain the key employees necessary to achieve the continued success of our business, being mindful of our desire to maintain low operating margins and control costs.

Prior to 2006, our founder and chairman of our board of directors (formerly our president and chief executive officer), Tom Sullivan, was responsible for making all non-equity based compensation decisions. Equity grants were not a regular part of our compensation program and very few equity grants had ever been made. In 2006, before Mr. Griffiths began serving as our chief executive officer, Mr. Sullivan continued to make all non-equity based compensation decisions, except for decisions regarding our annual bonus program, which were made in consultation with the board. Currently, Mr. Griffiths makes all non-equity based compensation decisions, subject to board oversight for annual bonus determinations. Equity grants are made by the board. As soon as practicable after the consummation of this offering, the compensation committee of our board of directors will assume responsibility for implementing and administering all aspects of our compensation and benefit plans and programs. We intend to have a compensation committee comprised solely of independent directors no later than the conclusion of the phase-in period required by the New York Stock Exchange for companies that are listing their shares in connection with an initial public offering.

Prior to 2004, our senior management consisted of Mr. Sullivan and a small team of executives at our Toano headquarters. In 2004, we began hiring additional members of senior management to manage our growth and strengthen our infrastructure with a view toward preparing for and consummating this offering, including the hiring of a new chief executive officer, a new chief information officer, a new vice president of operations and senior vice presidents of merchandising and direct marketing and advertising, during 2006 and 2007. By the end of 2006, we had significantly increased our senior management team at our Toano headquarters. As part of their respective compensation package, most of these new executives were granted stock options, which were intended to incentivize them to help achieve the successful completion of this offering and to strive to ensure our continued growth and success both before and after this offering.



## Table of Contents

Following consummation of this offering, under the leadership of our compensation committee, we will continue to manage our compensation system with the following goals:

to maintain a straightforward and flexible program that allows us to make adjustments in response to changes in market conditions;

to provide compensation packages necessary to attract and retain key executives to help ensure that we remain competitive;

to provide non-equity incentive compensation that depends on the executive's individual performance, and our financial performance, as compared against goals established by the compensation committee; and

to provide an appropriate link between compensation and the creation of shareholder value through equity awards tied to our long-term performance.

Based on our overall compensation philosophy, our compensation program for senior management currently consists of only four basic elements to further and balance these goals:

**Base Salary.** Existing compensation arrangements were negotiated with executives when they joined the company and, accordingly, we believe they reflect the compensation levels that were necessary to attract these executives. We intend to engage in benchmarking studies in the future to ensure that base salary levels remain competitive. We have not yet selected peer companies for these benchmarking purposes, although we currently expect to select peer companies from among those retail companies that have annual sales ranging from \$150.0 million to \$1.0 billion, with three- and five-year sales compound annual growth rates of at least 10%, but generally excluding those that are predominantly Internet- or catalog-based. In keeping with the theories underlying our commission-based compensation system for regional and store managers, our compensation for senior executives will continue to include performance-based compensation elements discussed below.

**Annual Cash Bonus Awards.** Under our Annual Bonus Plan for Executive Management (the Bonus Plan), our senior executives are eligible to receive an annual incentive bonus awarded in cash. Bonuses will be tied to each executive's individual performance and our achievement of objective earnings thresholds, in each case as specifically tailored each year to reflect our then-current goals.

**Equity Incentive Awards.** The long-term component of our compensation program consists of the grant of equity awards under our 2004 Stock Option and Grant Plan (the Option Plan), which are intended to create a mutuality of interest with shareholders by motivating our executive officers to manage our business so that our shareholders investment will grow in value over time.

**Performance-Based Commissions.** Certain of our executives whose responsibilities relate directly to our sales are also eligible to receive commissions based on the sales levels we achieve.

We believe this system closely aligns our senior executives' compensation with each executive's individual performance and with our performance on both a short-term and long-term basis and should assist us in attracting and retaining high-performing executives who will help us achieve continued success.

## Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

**Base Salary.** We are in the process of implementing annual performance reviews for senior management. Our president and chief executive officer, Jeffrey Griffiths, will conduct annual performance reviews of members of senior management, and our board will conduct annual evaluations of the chief executive officer's performance, in each case based on quantitative performance criteria such as sales, profitability and new account activity, and qualitative criteria such as business decisions, product and process suggestions and identification and development of business opportunities.

**Table of Contents**

**Annual Cash Bonus Awards.** Under the Bonus Plan, each executive officer is eligible to receive an annual cash bonus in an amount equal to a certain percentage of his or her base salary, based upon achievement of performance targets as set by the board of directors at the beginning of each calendar year. For calendar year 2006, performance targets for bonuses were based 50% on specified objective earnings thresholds for our audited earnings before income taxes, cash bonuses and non-cash stock compensation and 50% on a subjective analysis of individual operational goals established and/or approved by the chief executive officer (except for the chief executive officer, for whom the weighting was determined in the board's discretion).

The performance thresholds for the objective earnings component of our 2006 annual bonus plan were set in May 2006. This was the first time we set performance thresholds based on significant income statement or balance sheet line items, and it was done at a time when our budgeting process was still undergoing development. We believe that these objectives, as originally set, were aggressive and difficult to achieve. Shortly after the objectives were set, we made a number of changes to our operations, predominantly in connection with our transitioning toward becoming a public company, which made these objectives substantially more difficult to achieve. As a result, the original 2006 objectives do not reflect our current strategy or business model and are therefore not an appropriate benchmark against which to measure our past or future performance.

Our 2006 performance thresholds were as follows:

2006 Award Schedule	% of Objective Portion of Bonus Earned
<b>Earnings Thresholds</b>	<b>Bonus Earned</b>
Up to \$33,000,000	0
\$33,000,000 or above	20%
\$34,000,000 or above	40%
\$35,700,000 or above	60%
\$38,000,000 or above	70%
\$39,000,000 or above	90%
\$40,000,000 or above	100%

We did not have a specific bonus target for 2006. Our actual earnings (as calculated for purposes of making this determination) were below the minimum performance threshold, which we believe was principally due to the changes we made in our operations. Those changes, which included assembling an experienced executive team (including hiring a new chief executive officer), expanding our management team by hiring a number of senior vice presidents and a general counsel, restructuring our regional operations and increasing the number of regional managers, caused us to incur additional SG&A and other expenses during the period that had not been factored into our results in determining the objective performance thresholds. We also slowed the pace of new store openings to focus on expanding our store support infrastructure. See Management's Discussion and Analysis of Financial Condition and Results of Operations Overview.

Following are the target bonus amounts and actual bonus awards paid to each of these executive officers. We did not pay any portion of the bonus based on achievement of the objective earnings thresholds. The full amount of the bonus paid to each of these executive officers in 2006 was based solely upon satisfaction of the subjective individual operational goal criteria.

Executive	2006 Target Annual Bonus Amount	2006 Actual Annual Bonus Award
Mr. Sullivan	\$ 300,000	\$ 150,000
Mr. Griffiths	\$ 142,466	\$ 71,233
Mr. Terrell	\$ 67,500	\$ 33,750
Mr. Morrison	\$ 206,250	\$ 51,563
Mr. Pescara	\$ 112,500	\$ 42,188
Mr. Marcus	\$ 62,500	\$ 23,438
Mr. Greenan		

## **Table of Contents**

In the future, our compensation committee will be responsible for establishing target bonus amounts and performance goals for executive bonuses. Factors to be considered may include, among other things, both quantitative performance criteria such as sales, profitability and new account activity, as well as qualitative criteria such as business decisions, product and process suggestions and identification and development of new business opportunities. While our board of directors is in the process of establishing 2007 bonus targets, no final determination has yet been made with respect to them.

**Equity Incentive Awards.** Our equity awards are designed to encourage executive officers to think and act like shareholders. We want our executive officers to take appropriate risks in order to generate returns for our shareholders and share in any adverse consequences if those risks cause poor performance or operating losses. The equity awards also reward longevity and increase retention, as we do not maintain a defined benefit pension plan or provide other post-retirement medical or life benefits. Because no benefit is received unless our stock price performs favorably over the term of the equity incentive award, such awards are intended to provide incentives for executive officers to enhance our long-term performance, as reflected in stock price appreciation over the long term, thereby increasing shareholder value. Prior to the consummation of this offering, the only equity awards granted to our executives are stock options that were awarded at the time the executives were hired. Future equity awards under the Option Plan may be in the form of stock options, restricted stock or unrestricted stock, as our compensation committee determines in its discretion.

As a private company, we limited the number of times per year that we granted options to our employees (including our executives) and prepared a valuation of our common stock in connection with each grant. Our compensation committee will determine our practices for granting future equity awards to our executive officers and other employees following the consummation of this offering.

We intend to implement new equity compensation plans in connection with the completion of this offering.

**Performance-Based Commissions.** We may continue to provide executives whose responsibilities relate directly to our sales with the opportunity to earn commissions based on the sales performance of their respective areas of responsibility. However, as more fully described below, Mr. Greenan is no longer eligible to receive commission payments.

**Internal Pay Equity.** As described above, annual bonuses represent a significant portion of annual compensation for our executive officers. The target bonus for each executive officer is based on a percentage of his base salary. For our named executive officers who participated in the annual bonus program in 2006, target bonus percentages ranged from 100% of base salary for our current chief executive officer and former chief executive officer, Mr. Griffiths and Mr. Sullivan, respectively, to 50% of base salary for Messrs. Terrell, Pescara and Marcus, as discussed more fully below.

Half of each executive officer's annual bonus is based on the achievement by the company of objective performance targets. Accordingly, the level of achievement by the company will be the same for each of our executive officers, and will have the same impact on bonus compensation for all of our executive officers. The other half of the annual bonuses are linked to a subjective assessment of each executive's individual performance. In 2006, this assessment was performed by the board with respect to Messrs. Griffiths and Sullivan, and was performed by Messrs. Griffiths and Sullivan and approved by the board with respect to each of our other named executive officers. In the future, we intend to continue having the board or compensation committee approve annual bonus amounts payable to a select group of our top executive officers. We believe that basing a portion of the bonuses on achievement of

## Table of Contents

company-wide performance targets incentivizes all of our executives to work together in the interests of promoting shareholder value. We also believe it is appropriate to base a portion of each named executive officer's bonus on that person's individual performance. As a result of the structure of our bonus program, a material portion of our executive compensation may vary significantly from individual to individual and from year to year.

Mr. Griffiths' 2006 annual bonus target was 100% of his base salary. This bonus percentage was the result of negotiations between us and Mr. Griffiths at the time he commenced employment with us. His annual bonus, granted in accordance with the annual bonus program described above, was prorated based on the portion of the 2006 calendar year during which he served as chief executive officer. Mr. Griffiths' 2006 compensation also included a one-time signing bonus of \$100,000, as well as a commitment to propose a 745,000 option grant to Mr. Griffiths at the next meeting of the board, both of which he received pursuant to his employment agreement in September. The one-time signing bonus was intended to attract Mr. Griffiths to accept employment at Lumber Liquidators. The equity grant was intended to provide him with a significant stake in our long-term future performance as we prepared to launch this offering.

2006 annual bonus targets for our other executive officers were as follows: Mr. Sullivan, 100%; Mr. Terrell, 50%; Mr. Morrison, 75%; Mr. Pescara, 50% and Mr. Marcus, 50%. In light of Mr. Greenan's opportunity to earn a significant performance-based commission for 2006, as more fully described below, he was not eligible to participate in the 2006 annual bonus program. We believe that these target payment levels provide significant and appropriate incentives for each of these executive officers.

In addition, during fiscal year 2006, Mr. Greenan functioned to a significant extent as a regional manager and, as a result, we felt it was appropriate for his compensation to mirror the compensation of the regional store managers. As a result, he received commission payments based on store operations. As Mr. Greenan has transitioned to a more centralized managerial role, his overall compensation package more closely resembles the packages of the other executive officers and he is no longer eligible to receive commission payments. Similarly, Mr. Pescara participated in a commission program in 2006, and the commission payments comprised a portion of his compensation. Mr. Pescara will continue to participate in a commission arrangement as a result of his direct responsibility for sales.

Equity awards for 2006 were approved by the board. The number of options awarded to each of our named executive officers in 2006 (listed in the Summary Compensation Table below) was determined based on the executive's position in us and the length of his service to us.

***Policy on Code Section 162(m).*** As a private company, prior to the consummation of this offering we were not subject to the limits on deductibility of compensation set forth in Section 162(m) of the Internal Revenue Code. Section 162(m) denies publicly-held companies a tax deduction for annual compensation in excess of \$1.0 million paid to their chief executive officer or any of their four other most highly compensated executive officers employed on the last day of a given year, unless their compensation is based on qualified performance criteria. Subject to certain transition rules that apply to companies that first become publicly held in connection with an initial public offering such as this offering, to qualify for deductibility, these criteria must be established by a committee of independent directors and approved, as to their material terms, by that company's stockholders. In future years, we intend to structure our bonus and equity incentive programs so that they qualify as performance-based compensation under Section 162(m). However, our compensation committee may approve compensation or changes to plans, programs or awards that may cause the compensation or awards not to comply with Section 162(m) if it determines that such action is appropriate and in our best interests.

**Table of Contents****Executive Compensation****Summary Compensation Table**

The following table presents certain summary information concerning compensation paid to or earned by our president and chief executive officer, our former president and chief executive officer, our chief financial officer, our former chief financial officer and, each of our three other most highly compensated executive officers (determined as of the end of the last fiscal year) whose total annual salary and bonus exceeded \$100,000 during the fiscal year ended December 31, 2006 (together referred to herein as Named Executive Officers ).

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Option Awards (\$)(1)	Non-Stock Incentive Plan Compensation (\$)	All Other Compensation (\$)	Total (\$)
Thomas D. Sullivan	2006	299,091	150,000			9,205	458,296
Former president and chief executive officer; Chairman of our board of directors(2)							
Jeffrey W. Griffiths	2006	144,230	171,233	174,609			490,072
President and chief executive officer(3)							
Daniel E. Terrell	2006	134,750	33,750	53,651		2,605	224,756
Chief financial officer(4)							
Robert M. Morrison	2006	274,055	51,563	53,651		5,298	384,567
Senior vice president, store operations(5)							
Marco Q. Pescara	2006	156,351	42,188	18,502	18,494	35,769	271,304
Senior vice president, direct marketing and advertising(6)							
H. Franklin Marcus, Jr.	2006	122,720	23,438	53,651		9,457	209,266
Former chief financial officer; Vice president, finance; Treasurer(7)							
Tyler Greenan	2006	47,730		160,952	282,952	12,799	504,433
Vice president, store operations(8)							

- (1) Represents the dollar amount of compensation cost recognized by us in 2006, in accordance with SFAS 123 (R), of employee stock options. For a discussion of the assumptions relating to these valuations, see Summary of Significant Accounting Policies Stock-Based Compensation in Note 1 to our financial statements.
- (2) Mr. Sullivan stepped down as our president and chief executive officer effective September 18, 2006. He continues to serve as chairman of our board of directors. Compensation shown for Mr. Sullivan represents compensation for his services as president and chief executive officer. He did not receive compensation in 2006 for his services as a director. Mr. Sullivan remains employed by the company, and will continue to receive compensation in that capacity. All other compensation includes \$2,605 in group health plan contributions and life insurance premiums and \$6,600 in matching contributions to our 401(k) plan.
- (3) Mr. Griffiths was hired to serve as our chief executive officer as of September 18, 2006.
- (4) Mr. Terrell became our chief financial officer effective October 2006. All other compensation includes \$2,605 in group health plan contributions and life insurance premiums.
- (5) Mr. Morrison was hired to serve as our senior vice president, store operations as of January 2, 2006. All other compensation includes \$5,298 in group health plan contributions and life insurance premiums.
- (6)

## Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

Mr. Pescara was hired to serve as our senior vice president, direct marketing and advertising as of April 20, 2006. The \$18,494 represents a commission earned by Mr. Pescara. All other compensation includes reimbursement for \$32,491 in relocation expenses and \$3,278 in group health plan contributions and life insurance premiums.

**Table of Contents**

- (7) Mr. Marcus stepped down as our chief financial officer effective October 2006. All other compensation includes \$5,317 in group health plan contributions and life insurance premiums and \$4,140 in matching contributions to our 401(k) plan.
- (8) Non-Stock Incentive Plan Compensation represents a commission earned by Mr. Greenan. All other compensation includes \$7,684 in group health plan contributions and life insurance premiums and \$5,115 in matching contributions to our 401(k) plan.

**Grants of Plan-Based Awards**

The following table sets forth, for each of our Named Executive Officers, the grants of awards under any plan during the fiscal year ended December 31, 2006.

Name	Grant Date	Estimated Future Payouts Under Non-Equity Incentive Plan Awards (\$)			Estimated Future Payouts Under Equity Incentive Plan Awards (#)			All Other Stock Awards: Number of Shares of Stock or Units (#)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards (\$/Sh)	Grant Date Fair Value of Equity Awards(1)
		Threshold	Target	Max.	Threshold	Target	Max.				
Thomas D. Sullivan											
Jeffrey W. Griffiths	10/18/06								745,000	7.83	2,793,750
Daniel E. Terrell	7/13/06								114,761	7.58	429,206
Robert M. Morrison	7/13/06								114,761	7.58	429,206
Marco Q. Pescara	7/13/06								39,577	7.58	148,022
H. Franklin Marcus, Jr.	7/13/06								114,761	7.58	429,206
Tyler C. Greenan	7/13/06								344,282	7.58	1,287,615

- (1) For a discussion of the assumptions relating to these valuations, see Summary of Significant Accounting Policies Stock-Based Compensation in Note 1 to our financial statements.

**Discussion of the Summary Compensation Table and Grants of Plan-Based Awards Table**

**Employment Agreement with Jeffrey W. Griffiths.** Pursuant to the employment agreement entered into between us and Jeffrey W. Griffiths, Mr. Griffiths is employed as our president and chief executive officer for a four-year term commencing September 18, 2006. The agreement provides for an annual base salary of \$500,000, which may be increased based on an annual performance review. In addition, our board of directors in its discretion may award Mr. Griffiths an annual performance bonus, based on our financial performance and Mr. Griffiths' job performance, as described in more detail under Compensation Discussion and Analysis above. Under the agreement, Mr. Griffiths was granted options to purchase 745,000 shares of our stock (approximately 3% of our outstanding shares at that time) at fair market value as of October 18, 2006 (determined based on a valuation of the stock as of October 1, 2006). The options vest 25% on each of the first four anniversaries of grant, provided that the options will become fully vested upon the occurrence of a Griffiths Agreement Sale Event (defined as (i) our dissolution or liquidation, (ii) a sale of all or substantially all of our assets or (iii) a merger, reorganization or consolidation in which our stock is converted into or exchanged for securities of a successor entity and the holders of a majority of voting power prior to the transaction do not hold a majority of voting power of the successor entity following the transaction). Mr. Griffiths also received a \$100,000 signing bonus under the agreement after the first thirty days of his employment (all or half of which he would have been required to return to us if his employment was terminated for cause or if he resigned without good reason (each as defined in his employment agreement) within the first six months, or after the first six months but within the first eighteen months, of his employment, respectively).



## Table of Contents

The agreement also provides for certain payments in the event of termination, as described below under Potential Payments Upon Termination or Change of Control. Mr. Griffiths is bound under the agreement by a confidentiality provision, and non-competition and non-solicitation clauses that apply to his employment and for a period of two years following the later of the date of termination of Mr. Griffiths' employment and the date (if any) that a court enters a judgment enforcing the relevant provision.

**Employment Agreement with H. Franklin Marcus, Jr.** On August 27, 2004, we entered into an employment agreement with H. Franklin Marcus, Jr., our treasurer and vice president, finance and former chief financial officer. Under the agreement, Mr. Marcus base salary for his first year of employment was \$125,000, subject to annual review.

**Employment Arrangement with Tyler C. Greenan.** In 2006, we amended our compensation arrangement with Mr. Greenan, our vice president, store operations. Accordingly, his base salary is now \$230,000. He is eligible for an annual bonus as discussed in more detail in Compensation Discussion and Analysis above.

**Offer Letter Agreement with Robert M. Morrison.** On December 28, 2005, we entered into an offer letter agreement with Robert M. Morrison, our senior vice president, store operations. Under the agreement, Mr. Morrison's base salary for his first year of employment was \$275,000. He is eligible for an annual bonus as discussed in more detail in Compensation Discussion and Analysis above. At the time of hiring, Mr. Morrison received an initial option grant to purchase 114,760 shares of our stock and reimbursement for moving expenses (up to a maximum of \$125,000). The agreement also provides for certain payments in the event of termination, as described below under Potential Payments Upon Termination or Change of Control.

**Offer Letter Agreement with Marco Q. Pescara.** On March 27, 2006, we entered into an offer letter agreement with Marco Pescara, our senior vice president, direct marketing and advertising. Under the agreement, Mr. Pescara's base salary for his first year of employment was \$225,000. He is also entitled to receive a 0.25% monthly commission based on our e-commerce sales (subject to adjustment based on annual review) and an annual bonus as discussed in more detail in Compensation Discussion and Analysis above. At the time of hiring, Mr. Pescara received reimbursement for moving expenses and an initial stock option grant covering shares valued at \$300,000 at the time of the grant (based on a third-party valuation of our stock), which vests over a three-year period, provided that (a) vesting shall accelerate by one year upon completion of an initial public offering, (b) the options will become fully vested in the event of a 2004 Plan Sale Event (as defined below under the description of our 2004 Stock Option and Grant Plan) or a reorganization, recapitalization, reclassification, stock dividend, stock split or similar change in our stock that lowers our overall value (in which case, Mr. Pescara would be included in any cash distribution in the same manner as a stockholder). The agreement also provides for certain payments in the event of termination, as described below under Potential Payments Upon Termination or Change of Control.

**2004 Stock Option and Grant Plan.** Our 2004 Stock Option and Grant Plan, as amended effective October 18, 2006, provides for the grant of incentive and non-qualified stock options and restricted and unrestricted stock awards to officers, employees, consultants and other key persons (including prospective employees). There are 2,100,000 shares reserved for issuance under the plan, subject to adjustment to reflect changes in our stock due to corporate events such as reorganization, recapitalization, stock dividends, stock splits and reverse stock splits. The plan is administered by the board or a committee of the board selected by the board (the 2004 Plan Committee), provided that the 2004 Plan Committee may delegate authority to the chief executive officer to grant awards (up to a specified quantity) at fair market value pursuant to guidelines established by the 2004 Plan Committee for determining the exercise price of options, the conversion ratio or price of other awards, and vesting criteria. The exercise price for

---

**Table of Contents**

options granted under the plan must be at least fair market value on the applicable grant date. Fair market value is determined by the 2004 Plan Committee unless the stock is traded on a national securities exchange or automated quotation system, in which case the fair market value on any day will be the closing price reported on that day (except that on the first day on which the trading prices are so reported, the fair market value will be the price to the public stated in the final prospectus relating to our initial public offering). Options and restricted stock granted under the plan are non-transferable. At the request of a grantee and with the consent of the 2004 Plan Committee, grantees may receive a portion of cash compensation otherwise due to them in the form of unrestricted stock awards under the plan.

In the event of a 2004 Plan Sale Event (which includes our liquidation or dissolution, merger, sale of all or substantially all of our assets or a majority of our stock to an unrelated person, or any other transaction that results in a change in ownership of a majority of voting control of us), the plan and all outstanding options terminate unless the parties to the transaction arrange to assume or continue the options following completion of the transaction. In the event of such a termination, holders will be given a specified period of time before the transaction to exercise outstanding options that are then exercisable or will become exercisable as of the effective time of the 2004 Plan Sale Event (subject to consummation of such 2004 Plan Sale Event). The board may amend or terminate the plan at any time, and the 2004 Plan Committee may amend or cancel any outstanding award, provided such action does not adversely affect the rights of the holder of any outstanding award without his or her consent.

Option grant agreements issued under the plan typically provide that options vest in four equal installments on the first four anniversaries of the applicable grant date, provided that (a) upon the occurrence of an initial public offering, vesting of the option will be accelerated by one year and (b) upon the occurrence of a 2004 Plan Sale Event, (i) 50% of the unvested portion of the option will vest and (ii) if the option is assumed or continued by us or any successor of us, the option will vest in full upon a termination of the optionee's employment without cause or by the optionee for good reason (in each case, as defined in the option grant agreements) within 18 months following the 2004 Plan Sale Event. Following a termination of the optionee's employment, the agreements generally provide that the option will remain exercisable (to the extent vested) for 12 months (in the case of the optionee's death or disability) or 90 days (in the case of termination of employment for any other reason). Options terminate immediately upon a termination of the optionee's employment for cause. Shares acquired upon exercise of the option may be transferred only upon the optionee's death to his or her representatives, or to or for the benefit of certain family members, provided that we have a right of first refusal to purchase the shares prior to any such transfer. We also have the right to repurchase shares acquired through exercise of the option upon any termination of the optionee's employment or upon the optionee's bankruptcy, and have drag along rights in the event of certain events constituting a change in control of us. The transfer restrictions and drag along rights under the agreements terminate upon the occurrence of an initial public offering or 2004 Plan Sale Event. Optionees are generally bound under the agreements by confidentiality, non-solicitation (of both customers and employees) and non-competition provisions during the optionee's employment and for a period of 12 months following termination of his or her employment, violation of which would result in forfeiture of all unexercised options (whether or not vested) and all shares acquired upon the exercise of options.

***Lumber Liquidators, Inc. 2007 Equity Compensation Plan.*** In August 2007, our board of directors adopted, and our shareholders approved, the Lumber Liquidators, Inc. 2007 Equity Compensation Plan (the 2007 Plan). The 2007 Plan will be administered by our compensation committee or such other committee as our board of directors will appoint from time to time to administer and to otherwise exercise and perform the authority and functions assigned to such committee (the Committee).

The purpose of the 2007 Plan is to encourage and enable the employees, non-employee directors and other service providers of Lumber Liquidators and our related companies upon whose judgment, initiative and efforts we largely depend for the successful conduct of our business, to acquire a proprietary interest in

## **Table of Contents**

the company. It is anticipated that providing these persons with a direct stake in our welfare will assure a closer identification of their interests with our interests, thereby stimulating their efforts on our behalf and strengthening their desire to remain with us.

The material terms of the 2007 Plan are summarized below. The summary is not a complete description of the terms of the 2007 Plan.

*Eligible Participants and Types of Awards.* The 2007 Plan provides for the grant of non-qualified and incentive stock options ( Options ) and other stock-based awards, including without limitation restricted stock, restricted stock units, unrestricted stock awards and stock appreciation rights (Options and other stock based awards are referred to herein as the Awards ) to our employees, non-employee directors and other service providers. Awards may be settled in cash or in shares or other property pursuant to the terms of the relevant Award.

*Shares Available for Awards and Individual Award Limits.* The number of shares of our common stock authorized for issuance with respect to Awards granted under the 2007 Plan ( Shares ) is 4,300,000, reduced by (i) any Shares that have been issued under either the 2004 Stock Option and Grant Plan and the 2006 Equity Plan for Non-Employee Directors (collectively, the Prior Plans ), and (ii) any Shares that are subject to outstanding awards under the Prior Plans that have not been forfeited or cancelled. Of those Shares, the maximum number of Shares that may be covered by incentive stock options within the meaning of Section 422 of the Internal Revenue Code of 1986 may not exceed 4,300,000. Shares issued under the 2007 Plan may be either newly issued shares or treasury shares. No more than 1,500,000 Shares may be issued as restricted stock (either as a separate award or to settle restricted stock units) or unrestricted stock.

The maximum number of Shares that may be covered by Incentive Awards granted under the 2007 Plan to any single participant (a participant ) in any calendar year may not exceed 400,000 Shares.

Shares covered by Awards will only be counted as used to the extent they are actually issued and delivered to a participant (or a participant s permitted transferees). Accordingly, if an Award is settled for cash or if Shares are withheld to pay the exercise price of an Option or to satisfy any tax withholding requirement in connection with an Award, only the Shares issued (if any), net of the Shares withheld, will be deemed delivered for purposes of determining the number of Shares that remain available for delivery under the 2007 Plan. In addition, if Shares are issued subject to conditions which may result in the forfeiture, cancellation or return of such Shares to us, any portion of the Shares forfeited, cancelled or returned will be treated as not issued pursuant to the 2007 Plan. Furthermore, Shares owned by a participant (or a participant s permitted transferees) are tendered (either actually or through attestation) to us in payment of any obligation in connection with an Award, the number of Shares tendered will be added to the number of Shares that are available for delivery under the 2007 Plan.

Shares covered by Awards granted pursuant to the 2007 Plan in connection with the assumption, replacement, conversion or adjustment of outstanding equity-based awards in the context of a corporate acquisition or merger will not count as used under the 2007 Plan for these purposes.

*Effect on Prior Plans.* No further awards will be granted under any of the Prior Plans following this offering.

*Administration.* The Committee will from time to time designate those persons who will be granted Awards and the amount, type and other terms and conditions of such Awards. The Committee has full authority to administer the 2007 Plan, including authority to interpret and construe any provision of the 2007 Plan and the terms of any Award issued under it and to adopt such rules and regulations for administering the 2007 Plan, as it may deem necessary. Pursuant to this authority, on or after the date of

**Table of Contents**

grant of an Award under the 2007 Plan, the Committee may (i) accelerate the date on which any such Award becomes vested, exercisable or transferable, as the case may be; (ii) extend the term of any such Award, including, without limitation, extending the period following a termination of a participant's employment during which any such Award may remain outstanding; (iii) waive any conditions to the vesting, exercisability or transferability, as the case may be, of any such Award; or (iv) provide for the payment of dividends or dividend equivalents with respect to any such Award; provided that the Committee will not have any such authority to the extent that the grant of such authority would cause any tax to become due under Section 409A of the Internal Revenue Code.

*Significant Features of Awards.* The following is a description of the terms that apply to each Option issued under the 2007 Plan. Each Option will entitle the holder thereof to purchase a specified number of Shares. The exercise price of each Option will be at least equal to 100% of the fair market value of a Share on the date on which the Option is granted. Options will have terms that may not exceed ten years and will have vesting periods as determined by the Committee. Each Option will be exercisable in whole or in part, but no partial exercise of an Option will be for an aggregate exercise price of less than an amount determined by the Committee from time to time. Each agreement evidencing the award of each Option will specify the consequences with respect to such Option of the termination of the employment, service as a director or other relationship between us and the participant.

The Committee may also grant equity-based or equity-related Awards other than Options in such amounts and subject to such terms and conditions as the Committee determines. Each such Award may, among other things, (i) involve the transfer of actual Shares, either at the time of grant or thereafter, or payment in cash or otherwise of amounts based on the value of Shares; (ii) be subject to performance-based and/or service-based conditions; and (iii) be in the form of stock appreciation rights, phantom stock, restricted stock, restricted stock units, performance shares, deferred share units, share-denominated performance units or other full value stock awards. With respect to Awards of restricted stock or restricted stock units, the 2007 Plan specifies that vesting restrictions conditioned on employment and the passage of time may not expire less than three years from the date of grant (except that up to 100,000 Shares may be granted with a restriction of no less than one year), and restrictions conditioned on the achievement of performance goals or conditions may not expire less than one year from the date of grant. The Committee may, however, provide that restrictions will expire at any time as a result of the Disability, death or retirement of the 2007 Plan service provider or the occurrence of a change in control of the company.

*Performance-Based Compensation.* The Committee may grant Awards that are intended to qualify under the requirements of Section 162(m) of the Internal Revenue Code as performance-based compensation. The performance goals upon which the payment or vesting of any Award (other than Options) that is intended to so qualify depends may relate to one or more of the following performance measures: (i) pre-tax earnings, as shown in our annual report to shareholders, calculated in accordance with generally accepted accounting principles consistently applied by us; (ii) earnings per share, as shown in our annual report to shareholders, calculated in accordance with generally accepted accounting principles consistently applied by us; (iii) earnings before interest, taxes, depreciation and amortization calculated in accordance with generally accepted accounting principles consistently applied by us; (iv) sales; (v) market share; (vi) stock price; (vii) cash flow(s) (including operating or net cash flow(s)); (viii) financial return ratios; (ix) return measures, including return or net return on assets, net assets, equity, capital or gross sales; (x) adjusted pre-tax margin; (xi) operating margins, operating profits, and/or operating expenses; (xii) dividends; (xiii) net income or net operating income; (xiv) value of assets; (xv) market penetration with respect to specific designated products or product groups and/or specific geographic areas; (xvi) aggregate product price and other product measures; (xvii) expense or cost levels; (xviii) reduction of losses, loss ratios or expense ratios; (xix) reduction in fixed costs; (xx) operating cost management; (xxi) cost of capital; (xxii) debt reduction; (xxiii) productivity improvements; (xxiv) average inventory turnover; (xxv) satisfaction of specified business expansion goals or goals relating to

**Table of Contents**

acquisitions or divestitures; (xxvi) advertising efficiency; (xxvii) customer satisfaction based on specified objective goals or a company-sponsored customer survey; (xxviii) employee diversity goals or employee turnover; (xxix) supervision of litigation and information technology; and (xxx) goals relating to acquisitions or divestitures of subsidiaries or joint ventures. The targeted level or levels of performance with respect to such business criteria may be established at such levels and in such terms as the Committee may determine, in its discretion, including in absolute terms, on a per share basis (either basic or diluted), as a goal relative to performance in prior periods, or as a goal compared to the performance of one or more comparable companies or an index covering multiple companies.

Within 90 days after the beginning of a performance period, and in any case before 25% of the performance period has elapsed, we expect that the Committee will establish (i) performance goals and objectives for such performance period; (ii) target awards for each participant; and (iii) performance schedules or other objective methods for determining the applicable performance percentage to be applied to each such target award.

*General Plan Provisions.* The 2007 Plan provides for an adjustment in the number of Shares available to be issued under the 2007 Plan, the number of Shares subject to Awards and the exercise prices of certain Awards upon a change in our capitalization, a stock dividend or split, a merger or combination of Shares and certain other similar events.

The 2007 Plan also provides that participants may elect to satisfy certain federal income tax withholding requirements by remitting to us cash or, subject to certain conditions, Shares or by instructing us to withhold Shares payable to the participant.

Under the 2007 Plan, Awards may not be sold, pledged, assigned, hypothecated, transferred, or disposed of in any manner other than by will or by the laws of descent or distribution, except as permitted by the Committee on a general or specific basis.

Our board of directors may at any time suspend or discontinue the 2007 Plan or revise or amend it in any respect whatsoever, except that, no change shall be made that increases the total number of Shares reserved for Awards, materially modifies the requirements as to eligibility for participation in the 2007 Plan or materially increases the benefits accruing the participants in the 2007 Plan unless such change is approved by our shareholders, unless we or the Committee determines that no such shareholder approval is required under any applicable law, regulation or rule of a stock exchange applicable to the 2007 Plan.

We will not make any grants of Awards under the 2007 Plan following the tenth anniversary of the date that the 2007 Plan becomes effective.

The 2007 Plan provides for or permits accelerated vesting of certain types of Awards under certain circumstances in connection with a change in control of the company.

*Tax Consequences of the 2007 Plan.* The tax consequences of participation in the 2007 Plan for participants and us generally depend on the type of award issued to a participant. In general, if a participant recognizes ordinary income in connection with the grant, vesting or exercise of an award, we are entitled to a corresponding deduction equal to the amount recognized as income by the participant.

**Table of Contents****Outstanding Equity Awards at Fiscal Year-End**

The following table sets forth, for each of our Named Executive Officers, the outstanding equity awards as of the end of the fiscal year ended December 31, 2006.

Name	Option Awards					Stock Awards		
	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Options (#) (1)	Option Exercise Price (\$)	Option Expiration Date	Market Value of Shares or Units of Stock That Have Not Vested (\$)	Equity Incentive Plan Awards: Number of Unearned Shares, Units or Rights That Have Not Vested (#)	Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Rights That Have Not Vested (\$)
Thomas D. Sullivan								
Jeffrey W. Griffiths		745,000	745,000	7.83	10/18/2016			
Daniel E. Terrell		114,761	114,761	7.58	7/13/2016			
Robert M. Morrison		114,761	114,761	7.58	7/13/2016			
Marco Q. Pescara		39,577	39,577	7.58	7/13/2016			
H. Franklin Marcus, Jr.		114,761	114,761	7.58	7/13/2016			
Tyler C. Greenan		344,282	344,282	7.58	7/13/2016			

(1) Options shown were granted under our 2004 Stock Option and Grant Plan. The options held by each Named Executive Officer other than Mr. Pescara vest 25% on each of the first four anniversaries of grant. Mr. Pescara's options vest in three equal annual installments on the first three anniversaries of grant.

**Option Exercises and Stock Vested**

No Named Executive Officer exercised stock options, stock appreciation rights or similar instruments, and no equity-based awards vested, during the fiscal year ended December 31, 2006.

**Potential Payments Upon Termination or Change of Control**

Under his employment agreement, in the event of his disability or death, Mr. Griffiths is entitled to receive a prorated portion of his annual performance bonus. If (a) we terminate Mr. Griffiths' employment without Cause (as defined in his agreement), (b) Mr. Griffiths terminates his employment within 60 days following a Griffiths Agreement Sale Event (as defined above under the description of Mr. Griffiths' employment agreement) that results in a material reduction in his compensation or responsibilities or (c) Mr. Griffiths terminates his employment for Good Reason (as defined in his agreement), Mr. Griffiths is entitled to receive two times his base salary in either a lump sum or installments (at his election) and a prorated portion of his annual performance bonus. Upon the occurrence of a Griffiths Agreement Sale Event, Mr. Griffiths' options will become fully vested.

Under his offer letter agreement, if Mr. Morrison is terminated without cause prior to December 28, 2007, he is entitled to receive severance equal to his annual salary.

Under Mr. Pescara's offer letter agreement, if he is terminated other than for cause (as defined in his agreement), he would be entitled to receive a severance payment equal to one year's base salary, projected commissions and bonus. If the termination occurs within 24 months following a sale of us, he would be entitled to receive 18 months' base salary, projected commissions and

Edgar Filing: Lumber Liquidators, Inc. - Form 424B4

bonus. In addition, the options granted to Mr. Pescara at the time he was hired (shown above in the Outstanding Equity Awards at Fiscal Year-End table) would become fully vested in the event of a 2004 Plan Sale Event (as defined above under the description of our 2004 Stock Option and Grant Plan) or a reorganization,

## **Table of Contents**

recapitalization, reclassification, stock dividend, stock split or similar change in our stock that lowers our overall value (in which case, Mr. Pescara would be included in any cash distribution in the same manner as a stockholder).

Our other Named Executive Officers are not entitled to any severance payments upon termination of their employment or in connection with a change in control of us. If a change in control occurs, which constitutes a 2004 Plan Sale Event (as defined above under the description of our 2004 Stock Option and Grant Plan), the options held by our Named Executive Officers, as set forth in the Outstanding Equity Awards at Fiscal Year-End table above (other than options held by Mr. Griffiths and Mr. Pescara, which would vest pursuant to their respective employment and offer letter agreements as described above) would vest with respect to 50% of the unvested portion of the options. If such options were not assumed by us or a successor of us, the options would terminate upon the occurrence of a 2004 Plan Sale Event and optionees would be given a specified period of time prior to the transaction to exercise outstanding options that were then exercisable or (subject to consummation of the 2004 Plan Sale Event) that would become exercisable as of the effective time of the 2004 Plan Sale Event. If the options were assumed or continued by us or any successor of us, they would become fully vested if the optionee's employment were terminated without cause or by the optionee for good reason (in each case, as defined in the applicable stock option grant agreements) within 18 months following the 2004 Plan Sale Event. If a change in control that constituted a 2004 Plan Sale Event occurred as of December 31, 2006, the option spread for the options held by each of our Named Executive Officers would have been as follows: Mr. Griffiths, \$1,341,000; Mr. Terrell, \$117,630; Mr. Morrison, \$117,630; Mr. Pescara, \$81,133; Mr. Marcus, \$117,630; Mr. Greenan, \$352,889.

## **Other Agreements with Executive Officers**

We have entered into employment agreements with Jeffrey W. Griffiths, H. Franklin Marcus, Jr., Robert M. Morrison and Marco Q. Pescara. For a summary of these agreements, see Executive Compensation Discussion of the Summary Compensation Table and Grants of Plan-Based Awards Table.

We have entered into employee confidentiality and non-compete agreements with certain of our executive officers, and we have entered into stock option agreements containing certain restrictive covenants with other of our executive officers, and we have entered into both agreements with two of our executive officers. Each employee confidentiality and non-compete agreement provides that the executive generally will not disclose, either during or after employment, our proprietary information, and will not compete with us or solicit our customers, suppliers or employees for the duration of the executive's employment and for a period of 24 months following termination of employment. The restrictive covenants of each stock option agreement provide that the executive generally will not disclose our proprietary information, compete with us or solicit our customers, suppliers or employees for the duration of the executive's employment and for a period of 12 months following termination of employment.



---

**Table of Contents**

**CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS**

**Lease Arrangements**

As of September 30, 2007, we leased our Toano facility, which includes a store location, and 23 of our other store locations from ANO LLC ( ANO ), a company that is wholly owned by Tom Sullivan, our founder and the chairman of our board of directors. We leased 22, 19 and 9 of our other stores from ANO as of December 31, 2006, 2005 and 2004, respectively. These leases generally have five-year base periods and multiple five-year renewal periods. We also lease our Toano finishing, distribution and headquarters facility from ANO under an operating lease with a base period that runs through December 31, 2019. Our rent expense attributable to ANO was \$2.1 million, \$2.0 million and \$1.0 million in 2006, 2005 and 2004, respectively. Our future minimum lease payments to ANO under all of our leases with them were \$18.2 million as of September 30, 2007. These leases are described in more detail in Note 6 to our audited financial statements included elsewhere in this prospectus.

As of September 30, 2007, we leased one store location each from DORA Real Estate Company, LLC ( DORA ), Wood on Wood Road, Inc. ( Wood on Wood ) and BMT Holdings, LLC ( BMT ). DORA and Wood on Wood are wholly owned by Tom, and he has a 50% membership interest in BMT. Each lease is for a five-year base period and has a five-year renewal period. The lease with BMT is currently in the first year of its renewal period. Our rent expense attributable to DORA was \$0.02 million in each of 2006, 2005 and 2004. Our rent expense attributable to Wood on Wood was \$0.07 million in each of 2006, 2005 and 2004. Our rent expense attributable to BMT was \$0.05 million in each of 2006, 2005 and 2004.

We believe that the leases that we have signed to date with ANO, DORA, Wood on Wood and BMT are on fair market terms, and the stockholders agreement to which Tom and TA Associates are parties prevents entities affiliated with Tom from setting lease rates above market rates.

In addition, of our leases with lessors that are not owned in whole or in part by Tom, three were guaranteed by Tom as of September 30, 2007.

We have adopted new approval policies for related party transactions in connection with this offering. Pursuant to those policies, transactions between us and our directors, officers and employees are generally required to be approved by the disinterested members of the Board of Directors (or, once it has been formed, the audit committee). See Policy Concerning Related Party Transactions below.

**Investment By TA Associates**

In December 2004, we sold 7,952,018 shares of our series A convertible preferred stock for an aggregate amount of \$35 million (the Preferred Stock Purchase ) to TA IX L.P., TA/Atlantic and Pacific IV L.P., TA Strategic Partners Fund A L.P., TA Strategic Partners Fund B L.P. and TA Investors II L.P. (collectively, the TA Associates Funds ). TA Associates, Inc. ( TA Associates ) is the ultimate general partner or manager of each of the TA Associates Funds, and Richard Tadler, one of our directors, is a managing director of TA Associates. After the Preferred Stock Purchase, TA Associates was the only holder of our series A convertible preferred stock. In connection with the closing of this offering, TA Associates will convert all of its shares of preferred stock into common stock based on a formula set forth in our restated articles of organization. The conversion ratio as of the date of this prospectus was one-to-one. Accordingly, TA Associates will receive 7,952,018 shares of common stock upon conversion of all the series A convertible preferred stock. TA Associates will sell 2,066,667 shares of common stock in this offering.

## **Table of Contents**

### ***Stockholders Agreement***

In connection with the Preferred Stock Purchase, we entered into a stockholders agreement with Tom Sullivan and the TA Associates Funds relating to our shares of common stock, preferred stock and any other equity securities that we may issue and they may hold (collectively, the Agreement Shares). Among other things, the stockholders agreement places certain restrictions on the ability of Tom and the TA Associates Funds to transfer their Agreement Shares, gives rights of first refusal to the TA Associates Funds, Tom and, in certain circumstances, us, with respect to Agreement Shares sold by the TA Associates Funds or Tom and allows the TA Associates Funds, in certain circumstances, to sell their Agreement Shares in conjunction with a sale of Agreement Shares by Tom. In addition, the TA Associates Funds have preemptive rights in certain circumstances upon a sale by us of certain securities, including shares of our common stock. The stockholders agreement provides that we shall have five directors, one of whom shall be nominated by the TA Associates Funds and two of whom shall be nominated by Tom. The remaining two directors are independent, and both shall be nominated by Tom but must be deemed acceptable by the TA Associates Funds. Finally, among other things, we covenanted to furnish certain reports and financial statements to the TA Associates Funds, maintain certain insurance, permit certain inspections of our premises and obtain certain employee agreements. Except for certain covenants relating to liability insurance for directors and officers, compensation of directors and the provision of information to investors regarding certain tax matters, the provisions of the stockholders agreement relating to restrictions on transfer terminate upon the commencement of, and the remaining provisions of the stockholders agreement terminate upon the closing of, a Qualified Public Offering (as defined in our restated articles of organization). Although this offering is not expected to qualify as a Qualified Public Offering, we nonetheless expect to amend the stockholders agreement in connection with this offering.

### ***Registration Rights Agreement***

In connection with the Preferred Stock Purchase, we entered into a registration rights agreement with the TA Associates Funds relating to our shares of common stock held by the TA Associates Funds at any time. Subject to certain exceptions, including our right to defer a demand registration under certain circumstances, the TA Associates Funds have the right under the registration rights agreement to require us to register for public sale under the Securities Act all shares of common stock that they request be registered at any time following the expiration of the lock-up period in connection with this offering. After this offering, we are required to use our best efforts to qualify and remain qualified to register securities pursuant to a registration statement on Form S-3 under the Securities Act. The TA Associates Funds will also be entitled to piggyback registration rights with respect to any future registration statement we file for an underwritten public offering of securities. Under the registration rights agreement, we are responsible, subject to certain exceptions, for the expenses of any offering of the shares of the TA Associates Funds. The TA Associates Funds are subject to lock-up agreements for a period of 180 days following the date of this prospectus. The registration rights agreement does not include a liquidated damages clause and provides no penalty for liquidated damages.

### ***Other Matters Involving Tom Sullivan***

We are party to the Variable Plan, a stock-based agreement between Tom Sullivan and Kevin Sullivan, Tom's brother, who started our western U.S. operations and was our first regional manager, pursuant to which we generally guarantee Tom's cash payment obligation under the agreement. We account for that agreement as a variable performance plan. Under the Variable Plan, as amended in August 2005, Kevin has the right to a fixed ownership percentage of Lumber Liquidators, Inc. on a fully diluted basis, plus an additional ownership percentage based on certain performance criteria. The number of shares that may be acquired pursuant to the Variable Plan, shall be determined immediately prior to the completion of this offering, and will equal the sum of (a) a number of shares of common stock equal to 2.5% of our outstanding common stock, determined on a fully diluted basis and (b) a number of

## **Table of Contents**

shares of common stock having an aggregate value equal to 10.5% of the value of the Western Region of the company. For purposes of the Variable Plan, the Western Region means our operations in eleven western U.S. states as of August 1, 2005, together with certain additional specified operations in those states, subject to adjustment in certain circumstances. The value of the Western Region will be determined by multiplying the fair market value of the company by a fraction, the numerator of which is the net income of the Western Region for the immediately preceding 12 months (or portion thereof) and the denominator of which is our net income for the same period, in each case determined in accordance with generally accepted accounting principles consistently applied. We estimate that the number of shares that would have been issued to Kevin pursuant to the Variable Plan had the option been exercised on September 30, 2007 would have been approximately 926,000 shares. This right is exercisable for shares of common stock, to be contributed by Tom and which have been placed in escrow, in conjunction with an IPO or sales event. Kevin's right under the Variable Plan will be considered to be exercised in full immediately prior to the completion of the initial public offering and, accordingly, we do not expect to record any future charges relating to the Variable Plan other than an adjustment in the quarter, in which this transaction closes to reflect the difference between the estimated value of the common stock as of September 30, 2007 and the final closing price for the number of shares considered earned by Kevin. See Management's Discussion and Analysis of Financial Condition and Results of Operations Other Factors Affecting Our Results Equity Compensation Expenses.

The Variable Plan also contains various customary representations and warranties, put and call rights, termination provisions, certain lock-up provisions, and certain provisions that will terminate in connection with this offering, including a right of first refusal for Tom with respect to any disposal of the shares acquired by Kevin and a drag-along right in connection with various strategic transactions.

In 2004, we distributed cash of \$42.6 million to Tom, of which \$12.6 million consisted of cash distributions immediately prior to the TA Associates transaction, including \$5.0 million to enable him to pay taxes on deemed income during the period when we were an S corporation, and a \$30.0 million distribution related to the Preferred Stock Purchase. See Dividend Policy. In addition, pursuant to the terms of the Preferred Stock Purchase, Tom assumed a net liability related to a capitalized lease, and we recorded a \$0.6 million contribution from him in 2005.

As of December 31, 2006, Tom owed us approximately \$35,000 in connection with his personal use of our company's corporate credit card, which was paid in the first quarter of 2007. As of the date of this filing, Tom did not have an outstanding balance to us.

We expect to enter into arrangements to indemnify various parties, including Tom, against certain liabilities in connection with this offering, including liabilities under the Securities Act.

In August 2007, we conveyed two residential parcels of land unrelated to our business with a market land value assessed at less than \$0.05 million in aggregate in Martin County, Florida to ANO to complete a transfer which Tom and TA Associates had intended to effect in connection with the December 2004 Preferred Stock Purchase. See Investment by TA Associates above.

## **Policy Concerning Related Party Transactions**

In connection with this offering, we have adopted a formal written policy concerning related party transactions. A related party transaction is a transaction, arrangement or relationship involving us or a consolidated subsidiary (whether or not we or the subsidiary is a direct party to the transaction), on the one hand, and (i) a director, executive officer or employee of us or a consolidated subsidiary, his or her immediate family members or any entity that any of them controls or in which any of them has a substantial beneficial ownership interest; or (ii) any person who is the beneficial owner of more than 5% of our voting securities or a member of the immediate family of such person.

**Table of Contents**

The audit committee established prior to this offering (and, prior to that time, the disinterested members of the board of directors) evaluates each related party transaction for the purpose of recommending to the disinterested members of the board whether the transaction is fair, reasonable and within our company's policy, and should be ratified and approved by the board. At least annually, management will provide the audit committee or disinterested members of the board of directors, as the case may be, with information pertaining to related party transactions. Related party transactions entered into, but not approved or ratified as required by our policy concerning related party transactions, will be subject to termination by us or the relevant subsidiary, if so directed by the audit committee or the board, taking into account factors as such body deems appropriate and relevant.

**Table of Contents**

**PRINCIPAL AND SELLING STOCKHOLDERS**

The following tables set forth information known to us regarding beneficial ownership of our common stock as of October 20, 2007, by:

each person, or group of affiliated persons, who beneficially owns more than 5% of our outstanding shares of common stock;

each stockholder selling shares in this offering;

each of our named executive officers;

each of our directors; and

all of our executive officers and directors as a group.

Except as otherwise set forth in the footnotes below, and subject to applicable community property laws, to our knowledge, each person has sole voting and investment power over the shares shown as beneficially owned. See **Certain Relationships and Related Party Transactions** for a discussion of business relationships between us and certain of our stockholders, and **Management Executive Officers and Directors** for the positions and offices held by certain stockholders.

The number of shares beneficially owned by each stockholder is determined under rules promulgated by the SEC and generally includes voting or investment power over the shares. The table below assumes the underwriters do not exercise their option to purchase additional shares. The information does not necessarily indicate beneficial ownership for any other purpose. Under SEC rules, for purposes of the calculations in the table below, the number of shares of common stock deemed outstanding includes shares issuable upon exercise of options held by the respective person or group which may be exercised within 60 days after September 30, 2007. For purposes of calculating each person's or group's percentage ownership, shares of common stock issuable pursuant to stock options exercisable within 60 days after September 30, 2007 are included as outstanding and beneficially owned for that person or group, but are not treated as outstanding for the purpose of computing the percentage ownership of any other person or group.

As of October 20, 2007, there were 22,952,118 shares of our common stock outstanding (assuming the conversion into shares of common stock of all shares of our series A preferred stock).