

U.S. Auto Parts Network, Inc.  
Form 10-Q  
August 14, 2007

---

---

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

**Form 10-Q**

**(Mark One)**

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

**For the quarterly period ended June 30, 2007**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 001-33264**

**U.S. AUTO PARTS NETWORK, INC.  
(Exact name of registrant as specified in its charter)**

**Delaware  
(State or other jurisdiction of  
incorporation or organization)**

**68-0623433  
(I.R.S. Employer  
Identification No.)**

**17150 South Margay Avenue  
Carson, CA 90746  
(Address of Principal Executive Office) (Zip Code)**

**(310) 735-0085  
(Registrant's telephone number, including area code)**

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

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

As of August 13, 2007, the registrant had 29,833,192 shares of common stock, \$0.001 par value, outstanding.

---

---

---

**U.S. AUTO PARTS NETWORK, INC.**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2007**

**TABLE OF CONTENTS**

	<u>Page</u>	
<b>PART I. FINANCIAL INFORMATION</b>		
ITEM 1.	Financial Statements:	
	Condensed Consolidated Balance Sheets at June 30, 2007 (unaudited) and December 31, 2006	2
	Unaudited Condensed Consolidated Statements of Income for the Three and Six Months Ended June 30, 2007 and 2006	3
	Unaudited Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2007 and 2006	4
	Notes to Unaudited Condensed Consolidated Financial Statements	5
ITEM 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	11
ITEM 3.	Quantitative and Qualitative Disclosures About Market Risk	16
ITEM 4.	Controls and Procedures	16
<b>PART II. OTHER INFORMATION</b>		
ITEM 1.	Legal Proceedings	18
ITEM 1A.	Risk Factors	18
ITEM 2.	Unregistered Sales of Equity Securities and Use of Proceeds	29
ITEM 3.	Defaults upon Senior Securities	30
ITEM 4.	Submission of Matters to a Vote of Security Holders	31
ITEM 5.	Other Information	31
ITEM 6.	Exhibits	31

Unless the context requires otherwise, as used in this report, the terms “U.S. Auto Parts,” the “Company,” “we,” “us” and “our” refer to U.S. Auto Parts Network, Inc. and its subsidiaries, and the term “Partsbin” refers to All OEM Parts, Inc., ThePartsBin.com, Inc. and their affiliated companies, which we acquired in May 2006.

U.S. Auto Parts™, U.S. Auto Parts Network™, PartsTrain™, Partsbin™, Kool-Vue™ and Auto-Vend™ are our United States common law trademarks. All other trademarks and trade names appearing in this report are the property of their respective owners.

### **SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

*This report contains forward-looking statements that are based on our management's beliefs and assumptions and on information currently available to our management. In some cases, you can identify forward-looking statements by terms such as "anticipates," "believes," "could," "estimates," "expects," "intends," "may," "plans," "potential," "predicts," "projects," "should," "will," "would" and similar expressions intended to identify forward-looking statements. These forward-looking statements include but are not limited to statements regarding our anticipated sales, revenue, expenses, profits, capital needs, capital deployment, product offerings, competition and the status of our facilities. Forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. We discuss many of these risks in greater detail under the heading "Risk Factors" in Part II, Item 1A of this report. Given these uncertainties, you should not place undue reliance on these forward-looking statements. You should read this report and the documents that we reference in this report and have filed as exhibits to the report completely and with the understanding that our actual future results may be materially different from what we expect. Also, forward-looking statements represent our management's beliefs and assumptions only as of the date of this report. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.*

## PART I. FINANCIAL INFORMATION

## ITEM 1.

## Financial Statements

**U.S. AUTO PARTS NETWORK, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share amounts)

	June 30, 2007 (unaudited)	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 42,324	\$ 2,381
Accounts receivable, net	2,779	2,789
Inventory, net	11,519	8,796
Deferred income taxes	934	934
Other current assets	1,912	1,149
Total current assets	59,468	16,049
Property and equipment, net	4,516	2,716
Intangible assets, net	30,493	33,362
Goodwill	14,201	14,179
Deferred income taxes	1,703	1,703
Other non-current assets	152	1,901
Total assets	\$ 110,533	\$ 69,910
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 10,045	\$ 9,091
Accrued expenses	3,465	2,912
Line of credit	—	2,000
Notes payable	1,000	10,805
Capital leases payable, current portion	65	62
Other current liabilities	1,442	2,392
Total current liabilities	16,017	27,262
Notes payable, less current portion, net	—	21,922
Capital leases payable, less current portion	76	114
Total liabilities	16,093	49,298
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value; 10,000,000 and 11,100,000 shares authorized at June 30, 2007 and December 31, 2006, respectively; none and 11,055,425 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	—	11
Common stock, \$0.001 par value; 100,000,000 and 50,000,000 shares authorized at June 30, 2007 and December 31, 2006, respectively; 29,832,927 and 15,199,672	30	15

Edgar Filing: U.S. Auto Parts Network, Inc. - Form 10-Q

shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively		
Additional paid-in capital	141,692	68,906
Accumulated other comprehensive income	35	5
Accumulated deficit	(47,317)	(48,325)
Total stockholders' equity	94,440	20,612
Total liabilities and stockholders' equity	\$ 110,533	\$ 69,910

See accompanying notes to unaudited condensed consolidated financial statements.

**U.S. AUTO PARTS NETWORK, INC.**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(in thousands, except share and per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Net sales	\$ 42,112	\$ 26,966	\$ 85,855	\$ 44,971
Cost of sales	28,327	17,617	58,401	27,876
Gross profit	13,785	9,349	27,454	17,095
Operating expenses:				
General and administrative	3,655	2,290	6,531	4,255
Marketing	4,921	3,179	10,821	5,155
Fulfillment	1,862	1,213	3,579	2,365
Technology	507	323	956	517
Amortization of intangibles	2,100	947	4,154	951
Total operating expenses	13,045	7,952	26,041	13,243
Income from operations	740	1,397	1,413	3,852
Other income (expense):				
Loss from disposition of assets	—	—	—	(5)
Other income	3	3	5	157
Interest expense, net	545	(317)	265	(357)
Total other income (expense)	548	(314)	270	(205)
Income before income taxes	1,288	1,083	1,683	3,647
Income tax provision	515	472	675	316
Net income	\$ 773	\$ 611	\$ 1,008	\$ 3,331
Basic net income per share	\$ 0.03	\$ 0.04	\$ 0.04	\$ 0.24
Diluted net income per share	\$ 0.03	\$ 0.03	\$ 0.04	\$ 0.18
Shares used in computation of basic net income per share	29,832,927	14,120,952	26,679,905	13,663,020
Shares used in computation of diluted net income per share	29,853,346	20,772,428	28,142,830	18,099,520

See accompanying notes to unaudited condensed consolidated financial statements.

**U.S. AUTO PARTS NETWORK, INC.**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	<b>Six Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Operating activities</b>		
Net income	\$ 1,008	\$ 3,331
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	542	1,082
Amortization of intangibles	4,154	951
Non-cash interest expense	273	19
Loss from disposition of assets	—	5
Share-based compensation and other	1,030	292
Deferred income taxes	—	(982)
Changes in operating assets and liabilities:		
Accounts receivable, net	10	(2)
Inventory, net	(2,723)	1,538
Other current assets	(763)	2
Other non-current assets	1,749	(139)
Accounts payable and accrued expenses	1,469	703
Other current liabilities	(950)	(620)
Net cash provided by operating activities	5,799	6,180
<b>Investing activities</b>		
Additions to property, equipment and intangibles	(2,080)	(633)
Acquisition of assembled workforce	(1,286)	—
Acquisition of business, net of cash acquired	(22)	(24,453)
Net cash used in investing activities	(3,388)	(25,086)
<b>Financing activities</b>		
Payments on line of credit	(2,000)	—
Proceeds from notes payable, net of discount	—	31,705
Payments on notes payable	(32,000)	(96)
Proceeds from initial public offering, net of offering costs	71,537	—
Proceeds on issuance of Series A convertible preferred stock, net of offering costs	—	42,246
Payments of short-term financing	(35)	(223)
Proceeds from sale of common stock	—	150
Stockholder distributions	—	(1,700)
Recapitalization distribution	—	(50,000)
Net cash provided by financing activities	37,502	22,082
Effect of changes in foreign currencies	30	8
Net increase in cash and cash equivalents	39,943	3,184
Cash and cash equivalents at beginning of period	2,381	1,353
Cash and cash equivalents at end of period	\$ 42,324	\$ 4,537



See accompanying notes to unaudited condensed consolidated financial statements.

**U.S. AUTO PARTS NETWORK, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1—Summary of Significant Accounting Policies**

***Basis of Presentation***

The condensed consolidated financial statements of U.S. Auto Parts Network, Inc. (collectively with its subsidiaries, the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Securities and Exchange Commission (“SEC”) Form 10-Q and Article 10 of SEC Regulation S-X. In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments, consisting of normal recurring adjustments, necessary to present fairly the consolidated financial position of the Company as of June 30, 2007 and December 31, 2006, and the consolidated results of operations for the three and six months ended June 30, 2007 and 2006, and cash flows for the six months ended June 30, 2007 and 2006. Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. The results of operations for the three and six months ended June 30, 2007 are not necessarily indicative of those to be expected for the entire year. The accompanying consolidated financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2006, which was filed with the SEC on April 2, 2007.

***Use of Estimates***

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of net sales and expenses during the reporting period. Significant estimates made by management include, but are not limited to, the valuation of inventory, valuation of deferred tax assets and liabilities, estimated useful lives of property, equipment and software, valuation of intangible assets, including goodwill, recoverability of software development costs, estimation of sales returns and allowances, and the provision for doubtful accounts. Actual results could differ from these estimates.

***Recent Accounting Pronouncements***

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 157, “*Fair Value Measurements*” (“SFAS 157”). This standard 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. The Company is currently evaluating the impact of this statement on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, “*The Fair Value Option for Financial Assets and Financial Liabilities*” (“SFAS 159”) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective of SFAS 159 is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement is effective as of the beginning of any fiscal year beginning after November 15, 2007. The Company does not anticipate any material impact to its financial statements from the adoption of this standard.

***Seasonality***

Historically, the market for auto parts has been seasonal. Inclement weather conditions drive the demand for automobile body parts. During the winter months or wet season, more damage to automobiles occurs. Consumers undertake these repairs as they occur, leading to increased demand for automobile body parts during the winter. During the summer months, consumers often undertake projects to maintain and enhance the performance of their automobiles. This factor increases the demand for the Company's engine, performance and accessories products. The Company believes seasonality will continue to have a material impact on the Company's financial condition and results of operations in future years.

**Note 2—Inventory**

Inventories consist of finished goods available-for-sale and are stated at the lower of cost or market value, determined using the first in, first out (“FIFO”) method. The Company purchases inventory from suppliers both domestically and internationally and has recently entered into supply agreements with U.S. based suppliers and its primary drop-ship vendors. The Company believes that its inventoried products are generally available from more than one supplier and seeks to maintain multiple sources for its products, both internationally and domestically.

The Company primarily purchases products in bulk quantities to take advantage of quantity discounts and to improve inventory availability. Inventory is reported net of inventory reserves for excess or obsolete products, which are established based on specific identification of slow moving items and the evaluation of overstock considering anticipated sales levels. Gross inventory, inventory reserves and net inventory at June 30, 2007 and December 31, 2006 are as follows:

	June 30, 2007 (unaudited)	December 31, 2006
	(in thousands)	
Gross inventory	\$ 12,055	\$ 9,488
Inventory reserves	(536)	(692)
Total net inventory	\$ 11,519	\$ 8,796

**Note 3—Acquisition**

On May 19, 2006, the Company acquired all of the assets of Partsbin, an online retailer of auto parts primarily selling engine parts, performance parts and accessories to Do-It-Yourself consumers. The acquisition has been accounted for as a purchase in accordance with SFAS No. 141, “*Business Combinations*” and, accordingly, the acquired assets and liabilities have been recorded at fair value.

The total purchase price for the acquisition was \$50.0 million and consisted of \$25.0 million in cash, \$5.0 million in notes payable to the former stockholders of Partsbin and 1,983,315 shares of the Company’s common stock. In addition, the Company incurred \$573,000 of direct transaction costs related to the acquisition. Immediately following the Company’s initial public offering, the Company repaid \$4.0 million on the notes payable, resulting in \$1.0 million outstanding as of June 30, 2007. Interest expense on the notes payable was accrued in the accompanying consolidated statement of income.

The current allocation of the purchase price to assets acquired and liabilities assumed and various finite and indefinite lived intangible assets as well as goodwill is based on a preliminary valuation study. Amounts are considered preliminary until the final purchase price allocation is approved by both the Company and the selling stockholders of Partsbin according to the terms of the purchase agreement which includes the right of offset on the notes for any indemnification claims the Company could make against the selling stockholders of Partsbin.

The results of operations of Partsbin and the estimated fair market values of the acquired assets and liabilities have been included in the consolidated financial statements from the date of the acquisition.

**Note 4—Intangibles**

In May 2006, in connection with the acquisition of Partsbin, the Company recognized goodwill with an indefinite life in the amount of \$14.2 million and other intangible assets described in the table below. In April 2007, the Company acquired an assembled workforce, valued at \$1.3 million, from its outsourced call center provider in the Philippines, Access Worldwide which consisted of bringing the services of 171 sales and customer service agents in-house. See Note 5 below for further discussion regarding the details of this transaction.

Capitalized amounts are amortized on a straight-line basis. Amortization expense relating to intangibles totaled \$2.1 million, \$947,000, \$4.2 million and \$951,000 for the three and six months ended June 30, 2007 and 2006, respectively.

Intangibles, excluding goodwill, consisted of the following at June 30, 2007 and December 31, 2006:

	June 30, 2007			December 31, 2006		
	Gross Carrying Amount	Accum. Amort.	Net Carrying Amount	Gross Carrying Amount	Accum. Amort.	Net Carrying Amount
(in thousands)						
Intangible assets subject to amortization:						
Websites (5 year useful life)	\$ 28,988	\$ (6,468)	\$ 22,520	\$ 28,988	\$ (3,569)	\$ 25,419
Software (2-5 year useful life)	4,089	(1,521)	2,568	4,089	(839)	3,250
Vendor agreements (3 year useful life)	2,996	(1,114)	1,882	2,996	(614)	2,382
Assembled workforce (7 year useful life)	1,286	(45)	1,241	—	—	—
Purchased domain names (3 year useful life)	165	(113)	52	165	(84)	81
	37,524	(9,261)	28,263	36,238	(5,106)	31,132
Intangible assets not subject to amortization:						
Domain names (indefinite life)	2,230	—	2,230	2,230	—	2,230
Total	\$ 39,754	\$ (9,261)	\$ 30,493	\$ 38,468	\$ (5,106)	\$ 33,362

#### Note 5—Assembled Workforce

In April 2007, the Company entered into a purchase agreement with its outsourced call center provider to bring in-house certain sales and customer service employees based in the Philippines, who were providing support to the Company through this provider. The purchase price to acquire this assembled workforce was approximately \$1.7 million. In order to determine the accounting impact of this transaction, the Company obtained an independent third party valuation of the components of this contract. The valuation resulted in the recognition of an intangible asset, referred to as “assembled workforce,” with a fair value of \$1.3 million and an estimated useful life of seven years. The remaining \$440,000 was recorded as marketing expense.

Under the terms of the purchase agreement, approximately 182 of the provider’s employees were given the opportunity to become U.S. Auto Parts employees. As of the closing of this transaction, 171 of these employees agreed to transition over to direct employment by the Company’s Philippines subsidiary. The Company has also entered into an agreement to lease workstations in the provider’s facility in the Philippines for a period of six months. The Company is currently anticipating opening its own call center facility in the Philippines in the second half of 2007.

#### Note 6—Contingencies

The Company is subject to legal proceedings and claims which arise in the ordinary course of its business. Although occasional adverse decisions or settlements may occur, the potential loss, if any, cannot be reasonably estimated.

However, the Company believes that the final disposition of such matters will not have a material adverse effect on the financial position, results of operations or cash flow of the Company. The Company maintains various liability insurance coverages to protect the Company's assets from losses arising out of or involving activities associated with ongoing and normal business operations.

*Ford Global Technologies, LLC*

On December 2, 2005, Ford Global Technologies, LLC ("Ford") filed a complaint with the United States International Trade Commission ("USITC") against the Company and five other named respondents, including four Taiwan-based manufacturers. On December 12, 2005, Ford filed an amended complaint. Both the complaint and the amended complaint charged the Company and the other respondents with infringement of 14 design patents that Ford alleges cover eight parts on the 2004-2005 Ford F-150 truck (the "Ford Design Patents"). Ford asked the USITC to issue a permanent general exclusion order excluding from entry into the United States all automotive parts that infringe the Ford Design Patents and that are imported into the United States, sold for importation in the United States, or sold within the United States after importation. Ford also sought a permanent order directing the Company and the other respondents to cease and desist from, among other things, selling, marketing, advertising, distributing and offering for sale imported automotive parts that infringe the Ford Design Patents. The Company filed its response to the complaint with the USITC in January 2006 denying, among other things, that any of the Ford Design Patents is valid and/or enforceable and, further, denying each and every allegation of infringement. The Company also asserted several

affirmative defenses, any of which, if successful, would have precluded the USITC from granting any of Ford's requested relief. Some of these defenses were struck by the Administrative Law Judge ("ALJ") in response to motions by Ford. Additionally, four of the Ford Design Patents were dropped from the investigation at Ford's request. A hearing before the ALJ occurred in August 2006.

On December 4, 2006, the ALJ issued an initial determination finding three of the ten Ford Design Patents invalid, but upholding the validity and enforceability of the other seven Ford Design Patents, and ruling that the importation of automotive parts allegedly covered by these seven patents violates Section 337 of the Tariff Act of 1930, as amended. This initial determination was subject to review by the USITC. The Company and the other respondents accordingly filed a petition urging the Commission to review and reverse the portions of the initial determination finding seven of the ten patents valid, enforceable, and infringed. Ford, in turn, petitioned for review of the portion of the initial determination finding three of its design patents invalid. The ALJ's initial determination on all issues became the final determination of the USITC upon notice by the USITC on March 20, 2007 of its decision not to review the initial determination. On May 1, 2007, the Company and other respondents petitioned the USITC to reconsider its March 2007 ruling not to review the ALJ's determination regarding the seven Ford Design Patents found valid and infringed, in light of the Supreme Court's April 30, 2007 decision in *KSR International, Inc. v. Teleflex, Inc.* The USITC issued a "Notice of Commission Determination To Waive Reconsideration Rule Deadline And To Extend Target Date" on May 4, 2007. In this Notice, the USITC indicated that it would consider the petition and extended the target date for issuing a final order to June 6, 2007. Ford and the USITC's Office of Unfair Import Investigations opposed the Company's petition for reconsideration.

On June 6, 2007, the USITC denied the petition for reconsideration, terminated its investigation and issued a general exclusion order. The Commission denied Ford's request for a cease and desist order. The general exclusion order prohibits the importation, sale for importation, or sale in the United States after importation of aftermarket collision parts that infringe any of the seven Ford Design Patents previously determined to be valid. The final determination by the USITC was subject to review by the President of the United States, who is authorized to disapprove Commission orders for policy considerations. The mandatory 60-day Presidential review period ended on August 6, 2007, with the President taking no action. The Company has sixty days from the expiration of the Presidential review period to file a petition for review with the United States Circuit Court of Appeals for the Federal Circuit. The Company intends to vigorously pursue its appellate rights.

While the portion of the Commission's March 20, 2007 ruling finding a violation of Section 337 did not become final appealable order until the end of the Presidential review period, the Commission's finding of no violation of Section 337 as to the three of Ford's Design Patents held invalid was not subject to Presidential review, and became a final appealable order as of March 20, 2007. Accordingly, on May 18, 2007, Ford filed a Petition For Review at the United States Court of Appeals for the Federal Circuit seeking review and reversal of the portion of the USITC's March 20, 2007 Final Determination finding three of the Ford Design Patents invalid. That appeal is currently pending.

#### *Securities Litigation*

On March 24, 2007, a putative stockholder class action lawsuit was filed against the Company and certain officers and directors in the U.S. District Court for the Central District of California. The complaint alleges that the Company filed a false Registration Statement in connection with the Company's initial public offering in violation of Section 11 and Section 15 of the Securities Act of 1933, as amended (the "Securities Act"). On April 26, 2007, a second complaint containing substantially similar allegations was filed, and also included a claim under Section 12(a)(2) of the Securities Act. The complaints were consolidated on May 15, 2007. Plaintiffs seek compensatory damages, restitution, unspecified equitable relief, as well as attorneys' fees and costs. Defendants believe they have meritorious defenses and intend to vigorously defend the lawsuit. As such, the Company believes that a potential liability is not



probable or reasonably estimable and has recorded no amount related to this matter as of June 30, 2007. On August 13, 2007, the Company received a letter from the SEC that indicated that the SEC had commenced an informal inquiry into the events leading up to the Company's announcement on March 20, 2007 of its financial results for the fourth quarter and year ended December 31, 2006. The Company intends to fully cooperate with the SEC in this matter.

### Note 7—Comprehensive Income

The Company reports comprehensive income in accordance with SFAS No. 130, “Reporting Comprehensive Income,” which defines comprehensive income as non-stockholder changes in equity. Comprehensive income for each of the three and six month periods ended June 30, 2007 and 2006, respectively, includes the following:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
Net income	\$ 773	\$ 611	\$ 1,008	\$ 3,331
Foreign currency translation adjustments	21	10	30	8
Comprehensive income	\$ 794	\$ 621	\$ 1,038	\$ 3,339

### Note 8—Reserve For Sales Returns

Sales discounts are recorded in the period in which the related sale is recognized. Credits are issued to customers for returned products. Credits amounted to \$4.9 million and \$2.3 million for the three months ended June 30, 2007 and 2006, respectively. Likewise, credits amounted to \$8.9 million and \$3.7 million for the six months ended June 30, 2007 and 2006, respectively. The Company's sales returns and allowances reserve totaled \$596,000 and \$1.4 million at June 30, 2007 and December 31, 2006, respectively.

The following table provides an analysis of the reserve for sales returns:

	Balance at Beginning of Period	Charged to Revenue	Deductions	Balance at End of Period
	(in thousands)			
Six months ended				
Reserve for sales returns, June 30, 2006	\$ 170	\$ 3,674	\$ (3,322)	\$ 522
Reserve for sales returns, June 30, 2007	1,408	8,871	(9,683)	596

### Note 9—Income Taxes

For the three and six months ended June 30, 2007, the effective tax rate for the Company was 38.8% and 39.2%, respectively. The effective tax rate for the three and six months ended June 30, 2006 was 43.6% and 8.7%, respectively. The six months ended June 30, 2006 effective tax rate is significantly lower because the Company converted from S-corporation status to C-corporation status in March 2006. These rates differed from the statutory rates due to various permanent non-deductible tax items, including share-based compensation and other permanent differences. In July 2006, the FASB issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109” (“FIN 48”), which became effective for the Company on January 1, 2007. FIN 48 prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. As a result of the implementation of FIN 48, the Company recognized no material adjustment in

the liability for unrecognized income tax benefits and no corresponding interest or penalties. The tax years 2004 through 2006 remain open to examination by the major taxing jurisdictions to which the Company is subject.

### Note 10—Net Income Per Share

Net income per share has been computed in accordance with FASB Statement No. 128, “*Earnings Per Share*.” The following table sets forth the computation of basic and diluted net income per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
<b>Net Income Per Share</b>				
<b>(in thousands, except share and per share data)</b>				
Numerator:				
Net income	\$ 773	\$ 611	\$ 1,008	\$ 3,331
Denominator:				
Weighted-average common shares outstanding (basic)	29,832,927	14,120,952	26,679,905	13,663,020
Common equivalent shares from conversion of preferred stock	—	6,633,255	1,429,265	4,397,738
Common equivalent shares from common stock options and warrants	20,419	18,221	33,660	38,762
Weighted-average common shares outstanding (diluted)	29,853,346	20,772,428	28,142,830	18,099,520
Basic net income per share	\$ 0.03	\$ 0.04	\$ 0.04	\$ 0.24
Diluted net income per share	\$ 0.03	\$ 0.03	\$ 0.04	\$ 0.18

### Note 11—Share-Based Compensation

The Company accounts for share-based compensation in accordance with SFAS No. 123 (revised 2004), “Share-Based Payment” (“SFAS 123(R)”), which was adopted on January 1, 2006. No stock options were granted prior to January 1, 2006. All stock options issued to employees are recognized as share-based compensation expense in the financial statements based on their respective grant date fair values, and are recognized within the statements of income as general and administrative, marketing, fulfillment or technology expense, based on employee departmental classifications.

Under this standard, the fair value of each share-based payment award is estimated on the date of grant using an option pricing model that meets certain requirements. The Company uses the Black-Scholes option pricing model to estimate the fair value of share-based payment awards. The determination of the fair value of share-based payment awards utilizing the Black-Scholes model is affected by the Company’s stock price and a number of assumptions, including expected volatility, expected life, risk-free interest rate and expected dividends. As of June 30, 2007, the Company did not have an adequate history of market prices of its common stock as the Company only recently became a public company, and as such the Company estimates volatility in accordance with SAB No. 107 using historical volatilities of similar public entities. The expected life of an award is based on a simplified method which defines the life as the average of the contractual term of the option and the weighted average vesting period for all open tranches. The risk-free interest rate assumption is based on observed interest rates appropriate for the terms of awards. The dividend yield assumption is based on the Company’s expectation of paying no dividends. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

For non-employees, the Company accounts for share-based compensation in accordance with EITF No. 96-18, “*Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with*

*Selling, Goods or Services.*” Equity instruments awarded to non-employees are periodically re-measured as the underlying awards vest unless the instruments are fully vested, immediately exercisable and non-forfeitable on the date of grant.

There was \$8.9 million of unrecognized compensation expense related to stock options as of June 30, 2007, which expense is expected to be recognized over a weighted-average period of 3.3 years. The table below summarizes stock option activity during the six months ended June 30, 2007, which resulted in share-based compensation expense as follows:

	<b>Six Months Ended June 30, 2007</b>	
	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
Options outstanding, December 31, 2006	2,786,532	\$ 8.74
Granted	2,225,469	6.48
Exercised	—	—
Expired	—	—
Forfeited	(145,393)	8.88
Options outstanding, June 30, 2007	4,866,608	\$ 7.70
Options exercisable, June 30, 2007	2,789,139	\$ 8.86

#### **Note 12—Subsequent Event**

On August 8, 2007, the Company's Philippines subsidiary entered into two new lease agreements. The Company plans to use this space to expand its current operations. Under the terms of the first lease agreement, the Company will add an additional 526 square meters of space for a period of twelve months, effective September 1, 2007 for monthly rent of approximately \$3,000. Under the terms of the second lease agreement, the Company will add an additional 214 square meters of space for a period of eleven months, effective November 1, 2007 for monthly rent of approximately \$1,000.

## ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Cautionary Statement

*You should read the following discussion and analysis in conjunction with our unaudited condensed consolidated financial statements and the related notes thereto contained in Part I, Item 1 of this Report. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the year ended December 31, 2006 and subsequent reports on Forms 10-Q and 8-K, which discuss our business in greater detail. The section entitled "Risk Factors" set forth below, and similar discussions in our other SEC filings, describe some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this Report and in our other filings with the SEC, before deciding to purchase, hold or sell our common stock.*

### Overview

We are a leading online provider of aftermarket auto parts, including body parts, engine parts and performance parts and accessories. Our user-friendly websites provide customers with a broad selection of SKUs, with detailed product descriptions and photographs. Our proprietary product database maps our SKUs to product applications based on vehicle makes, models and years. We principally sell our products to individual consumers through our network of websites and online marketplaces. Our flagship websites are located at [www.partstrain.com](http://www.partstrain.com) and [www.autopartswarehouse.com](http://www.autopartswarehouse.com). We believe our strategy of disintermediating the traditional auto parts supply channel and selling products directly to customers over the Internet allows us to more efficiently deliver products to our customers while generating higher margins.

*Our History.* We were formed in 1995 as a distributor of aftermarket auto parts and launched our first website in 2000. We rapidly expanded our online operations, increasing the number of SKUs sold through our e-commerce network, adding additional websites, improving our Internet marketing proficiency and commencing sales in online marketplaces. As a result, our business has grown consistently since 2000, generating net sales of \$85.9 million for the six months ended June 30, 2007.

*International Operations.* In April 2007, we entered into a purchase agreement to bring in-house certain sales and customer service employees based in the Philippines who were providing support to us through our outsourced call center provider, Access Worldwide. Under the terms of this purchase agreement, approximately 182 employees of Access Worldwide were given the opportunity to become employees of our Philippines subsidiary and join our existing direct employees in the Philippines. As of the closing of this transaction, approximately 171 of the Access employees had agreed to transition over to direct employment by our Philippines subsidiary. The purchase price for the right to acquire this assembled workforce was approximately \$1.7 million. We are currently planning to open a new call center in the Philippines in the second half of 2007 to accommodate the additional employees and expect to spend up to \$1.0 million on such facility in 2007. In addition to our Philippines operations, we have outsourced call center operations in India and own a Canadian subsidiary to facilitate sales of our products in Canada. We believe that the cost advantages of our offshore operations provide us with the ability to grow our business in a cost-effective manner, and we expect to continue to add headcount and infrastructure to our offshore operations.

*Partsbin Acquisition.* In May 2006, we completed the acquisition of Partsbin. As a result of this acquisition, we expanded our product offering and product catalog to include performance parts and accessories and additional engine parts, enhanced our ability to reach more customers, significantly increased our net sales and added a complementary, drop-ship order fulfillment method. Partsbin also expanded our international operations by adding two outsourced call centers in the Philippines and in India, as well as a Canadian subsidiary to facilitate sales in Canada. We also

augmented our technology platform and expanded our management team. The purchase price for Partsbin consisted of \$25.0 million in cash, promissory notes in the aggregate principal amount of \$5.0 million payable to the former stockholders of Partsbin and 1,983,315 shares of our common stock. We continue to integrate Partsbin and we may pursue additional acquisition opportunities in the future to increase our share of the aftermarket auto parts market or expand our product offerings.

### Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations is based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these unaudited condensed consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, sales returns and allowances, uncollectible receivables, inventory reserves, intangible and other long-lived assets and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. There were no significant changes to our critical accounting policies during the six months ended June 30, 2007, as compared to those policies disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2006.

In June 2006, the FASB issued FIN 48, which became effective for us beginning January 1, 2007. FIN 48 addresses the determination of how tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN 48, we must recognize the tax benefit from an uncertain tax position only if it is more-likely-than-not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate resolution. The impact of our reassessment of our tax positions in accordance with FIN 48 did not have a material impact on our results of operations, financial condition or liquidity. For additional information regarding the adoption of FIN 48, see Note 9 of Notes to Unaudited Condensed Consolidated Financial Statements in Part I, Item 1 of this report.

### Results of Operations

The following table sets forth certain unaudited statements of income data for the periods indicated:

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2007	2006	2007	2006
	(unaudited)			
	(in thousands)			
Net sales	\$ 42,112	\$ 26,966	\$ 85,855	\$ 44,971
Cost of sales	28,327	17,617	58,401	27,876
Gross profit	13,785	9,349	27,454	17,095
Operating expenses:				
General and administrative	3,655	2,290	6,531	4,255
Marketing	4,921	3,179	10,821	5,155
Fulfillment	1,862	1,213	3,579	2,365
Technology	507	323	956	517
Amortization of intangibles	2,100	947	4,154	951
Total operating expenses	13,042	7,952	26,041	13,243

Edgar Filing: U.S. Auto Parts Network, Inc. - Form 10-Q

Income from operations	740	1,397	1,413	3,852
Other income (expense):				
Loss from disposition of assets	—	—	—	(5)
Other income	3	3	5	157
Interest income (expense), net	545	(317)	265	(357)
Total other income (expense)	548	(314)	270	(205)
Income before income taxes	1,288	1,083	1,683	3,647
Income tax provision	515	472	675	316
Net income	\$ 773	\$ 611	\$ 1,008	\$ 3,331

**Three and Six Months Ended June 30, 2007 Compared to Three and Six Months Ended June 30, 2006**

*Net Sales and Gross Margin*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
Net sales	\$ 42,112	\$ 26,966	\$ 85,855	\$ 44,971
Cost of sales	28,327	17,617	58,401	27,876
Gross profit	\$ 13,785	\$ 9,349	\$ 27,454	\$ 17,095
Gross margin	32.7%	34.7%	32.0%	38.0%

Net sales increased 55.9% and 90.9% to \$42.1 million and \$85.9 million for the three and six months ended June 30, 2007, from the same periods in the previous year. The increase in net sales in both periods was the result of organic growth across all sales channels and the acquisition of Partsbin in May 2006. This acquisition added a significant number of SKUs in performance parts, accessories and engine parts to our product offering. We believe organic sales growth in 2007 benefited from a broader product selection as well as an increase in the number of unique monthly visitors to our websites.

Our e-commerce sales grew by 61.3% and 111.3% to \$32.1 million and \$65.3 million for the three and six months ended June 30, 2007. Our online marketplace sales grew by 48.6% and 69.6% to \$5.2 million and \$11.7 million for the three and six months ended June 30, 2007. The increase in both e-commerce and online marketplace sales included the contribution from Partsbin product sales since May 2006.

The total number of e-commerce orders increased 60.0% and 111.7% to 256,000 and 525,000 orders for the three and six months ended June 30, 2007. The average order value increased during the three months ended June 30, 2007 to \$125 versus \$124 during the same period in the previous year. The average order value for the six months ended June 30, 2007 remained stable at \$125 versus the same period in the previous year.

Net sales of our Kool-Vue product-line and sales of other products through our wholesale channel remained relatively constant in absolute dollars for both the three and six months ended June 30, 2007 compared to the same periods in the prior year, but declined as a percentage of net sales. We anticipate that sales through our wholesale channel and Kool-Vue product line will continue to decline as a percentage of net sales in the future due to our primary focus on our online business.

We have historically experienced seasonality in our business. We expect seasonality to continue in future years as automobile collisions during inclement weather generally creates increased demand for body parts in winter months and consumers often undertake projects to maintain and enhance the performance of their automobiles in the summer months. We anticipate that seasonality will continue to have a material impact on our financial condition and results of

operations during any given year.

While gross profit increased largely as a function of higher sales volumes, as discussed above, the decrease in gross margins of 2.0% and 6.0% to 32.7% and 32.0% for the three and six months ended June 30, 2007 was primarily due to the partial inclusion of drop-ship products in the 2006 results, which generally carry lower gross margins. For the three and six months ended June 30, 2007, cost of freight increased in absolute dollars as a result of the increase in net sales, yet favorable shipping terms with our drop-ship suppliers caused freight expense as a percentage of net sales to drop from 13.5% of net sales for the six months ended June 30, 2006 to 12.8% of net sales for the six months ended June 30, 2007. Freight expense as a percentage of net sales for the three months ended June 30, 2007, however increased to 12.5% from 11.9% for the same period in the previous year.

#### *General and Administrative Expense*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
General and administrative expense	\$ 3,655	\$ 2,290	\$ 6,531	\$ 4,255
Percent of net sales	8.7%	8.5%	7.6%	9.5%

General and administrative expense increased 59.6% and 53.5% for the three and six months ended June 30, 2007, from the same periods in the previous year, which was primarily due to an increase of \$307,000 and \$878,000, in merchant fees related to higher online sales. Merchant fees remained relatively constant as a percentage of net sales, however during both periods. In addition, this increase reflects higher payroll and related expenses in the amount of \$203,000 for the three months ended June 30, 2007 and \$454,000 for the six months ended June 30, 2007, which was largely due to additional personnel. The increase also includes \$494,000 and \$806,000 of share-based compensation expense related to stock options for the three and six months ended June 30, 2007. In addition, there were additional expenses incurred relating to legal and professional fees and insurance coverage not incurred in the previous year. Legal and professional fees for the three and six months ended June 30, 2007 were \$660,000 and \$873,000, respectively. The increase in legal and professional fees relates to costs incurred for the pending securities class action litigation and compliance related matters for operating as a public company. The increase in general and administrative expense was partially offset by a \$351,000 reduction in software amortization for the three months ended June 30, 2007 and \$712,000 for the six months ended June 30, 2007.

During the three and six months ended June 30, 2007, we recognized \$494,000 and \$806,000 of share-based compensation, determined in accordance with SFAS 123(R). Based on options outstanding as of June 30, 2007, we expect to recognize \$8.9 million in additional expense in the following periods:

Remaining six months ending December 31, 2007	\$1.6 million
Year ending December 31, 2008	\$2.8 million
Year ending December 31, 2009	\$2.7 million
Year ending December 31, 2010	\$1.6 million
Five months ending May 31, 2011	\$232,000

We anticipate that we will incur increased general and administrative expense throughout 2007 and in future periods related to operating as a public company due to increased legal and accounting fees, higher insurance premiums, higher personnel and employee benefit costs and increased non-employee director costs. We expect that the costs of compliance associated with the transition to and operation as a public company, including the requirements relating to improving and documenting our internal controls and procedures, as well as changes in corporate governance practices, will be significant. In addition, complying with SEC inquiries and defending securities litigation against us

could result in substantial costs, which could cause our general and administrative expense to increase in the future.

### Marketing Expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
Marketing expense	\$ 4,921	\$ 3,179	\$ 10,821	\$ 5,155
Percent of net sales	11.7%	11.8%	12.6%	11.5%

Marketing expense increased 54.8% and 109.9% for the three and six months ended June 30, 2007, respectively from the same periods in the previous year primarily due to higher personnel costs of \$1.1 million and \$2.4 million, respectively related to the expansion in our sales and marketing team. Advertising cost during the three months ended June 30, 2007 was \$2.2 million or \$301,000 higher than the prior year period. For the six months ended June 30, 2007, advertising cost was \$5.7 million or \$2.5 million higher than in the six months period ended June 30, 2006. The majority of the expense was incurred in the first quarter of 2007 and we have reduced this expense in the second quarter of 2007.

In addition, in April 2007, we completed the acquisition of our Philippines sales force from our outsourced call center provider. As of June 30, 2007, 171 employees had transitioned to direct employment with our Philippines subsidiary. For the second half of 2007, we expect our personnel costs included in marketing expense to increase as a result of this additional headcount. We anticipate this increase to be fully offset, however by a reduction in our outsourced services expense as a result of bringing these capabilities in-house. The purchase price for the assembled workforce was approximately \$1.7 million. Of this amount, approximately \$420,000 was included as marketing expense during the first three months of 2007. The approximate remaining \$1.3 million was capitalized as an intangible asset in accordance with SFAS 142 "Goodwill and Other Intangible Assets." This intangible will be amortized over seven years beginning in April 2007.

### Fulfillment Expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
Fulfillment expense	\$ 1,862	\$ 1,213	\$ 3,579	\$ 2,365
Percent of net sales	4.4%	4.5%	4.2%	5.3%

Fulfillment expense increased 53.5% and 51.3% for the three and six months ended June 30, 2007 from the same periods in the previous year primarily due to \$478,000 and \$909,000, in additional personnel costs. We expanded the number of warehouse and purchasing employees during the first six months of 2007 in order to meet increased sales volume.

### Technology Expense

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
Technology expense	\$ 507	\$ 323	\$ 956	\$ 517
Percent of net sales	1.2%	1.2%	1.1%	1.1%



Technology expense increased 57.0% and 84.9% for the three and six months ended June 30, 2007 from the same periods in the previous year primarily due to higher communication fees of \$145,000 and \$325,000, to support the expansion of our communications infrastructure. During 2007, we expect technology expense as a percent of net sales to continue to increase due to the hiring of additional employees and increased investment in our overall technology platform.

#### *Amortization of Intangibles*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
Amortization of intangibles	\$ 2,100	\$ 947	\$ 4,154	\$ 951
Percent of net sales	5.0%	3.5%	4.8%	2.1%

Amortization of intangibles increased 121.8% and 336.8% for the three and six months ended June 30, 2007 primarily due to the intangible assets acquired pursuant to the acquisition of Partsbin completed in May 2006 and the assembled workforce acquired in April 2007. We preliminarily estimate aggregate amortization expense related to these acquisitions will be as follows:

Remaining six months ending December 31, 2007	\$4.2 million
Year ending December 31, 2008	\$8.4 million
Year ending December 31, 2009	\$6.9 million
Year ending December 31, 2010	\$6.0 million
Year ending December 31, 2011 and beyond	\$2.9 million

#### *Other Income (Expense), Net*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
	(in thousands)			
Other income (expense), net	\$ 548	\$ (314)	\$ 270	\$ (205)
Percent of net sales	1.3%	(1.2%)	0.3%	(0.5%)

The increase in other income (expense), net during the three months ended June 30, 2007 was primarily due to an increase of \$531,000 in interest income related to the higher cash balances. For the six months ended June 30, 2007, other income (expense), net included \$273,000 of accelerated non-cash interest expense from the write-off of the remaining debt discount during the first three months of 2007. Upon completion of our initial public offering, we reduced our long-term indebtedness by approximately \$28.0 million, which will significantly decrease our interest expense for the balance of 2007.

We expect to continue to record higher interest income throughout 2007 relative to 2006 due to investing the proceeds of the initial public offering. Our investment policy seeks to preserve principal, maintain liquidity and provide for diversification. All investments generally will be AAA rated to minimize credit and market risk exposure. A tax efficient strategy may be used to maximize the ultimate return on investments.

## **Liquidity and Capital Resources**

We have historically funded our operations from cash generated from operations, credit facilities, bank and stockholder loans, equity financing and capital lease financings. At June 30, 2007, the only notes payable outstanding related to \$1.0 million payable to the former stockholders of Partsbin. We had no balance outstanding under our term loans or our bank line of credit, which expires on July 31, 2009 and bears interest at prime minus 0.5%.

We had cash and cash equivalents of \$42.3 million as of June 30, 2007, representing a \$39.9 million increase from \$2.4 million as of December 31, 2006. The increase in our cash and cash equivalents as of June 30, 2007 was primarily due to the net proceeds from our initial public offering that was completed in February 2007. We received net cash proceeds from our initial public offering of approximately \$71.5 million (after deducting the underwriting discounts and commissions and offering expenses). Approximately \$28.0 million of the net proceeds from the offering was used to repay our outstanding indebtedness of approximately \$18.0 million and \$10.0 million under two term loans to our commercial lender. In addition, we paid \$4.0 million on the notes payable to the former stockholders of Partsbin.

We had working capital of \$43.5 million as of June 30, 2007, which was primarily due to the cash generated from our initial public offering. We anticipate that our existing cash balances, cash generated from operations and funds available under our line of credit will be sufficient to meet our working capital needs and expected capital expenditures for at least the next twelve months. Our future capital requirements may, however, vary materially from those now planned or anticipated. Changes in our operating plans, lower than anticipated net sales, increased expenses or other events, including those described in "Risk Factors," may cause us to seek additional debt or equity financings in the future. Financings may not be available on acceptable terms, on a timely basis, or at all, and our failure to raise adequate capital when needed could negatively impact our growth plans, our financial condition, and results of operations.

In June 2007, we opened a new distribution center in Tennessee. This distribution center is operated by a third party and is intended to stock and distribute performance parts and accessories. We intend to continue to add inventory to this location during the remainder of 2007. In addition to this third party distribution center, we are assessing the feasibility and economic value of opening a separate distribution facility in Tennessee that would be operated by us and house a broader range of product categories. We expect to finalize our plans on this distribution center in the second half of 2007.

Our Philippines subsidiary entered into two new lease agreements in August 2007. This facility expansion will be used to expand our non-call center operations including marketing, catalog, technology and administrative personnel. We anticipate this facility to be operational by the end of 2007. While this new facility is being setup, we are renting workstations from a third party. We expect to spend up to \$1.0 million on this facility in the second half of 2007.

## **Seasonality**

We believe our business is subject to seasonal fluctuations. We have historically experienced higher sales of body parts in winter months when inclement weather and hazardous road conditions typically result in more automobile collisions. Engine parts and performance parts and accessories have historically experienced higher sales in the summer months when consumers have more time to undertake elective projects to maintain and enhance the performance of their automobiles and the warmer weather during that time is conducive for such projects. We expect the historical seasonality trends to continue to have a material impact on our financial condition and results of operations.

## **Inflation**

Inflation has not had a material impact upon our operating results, and we do not expect it to have such an impact in the near future. We cannot assure you that our business will not be affected by inflation in the future.

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

We do not use financial instruments for trading purposes, and do not hold any derivative financial instruments that could expose us to significant market risk. Our primary market risk exposure with regard to financial instruments is changes in interest rates. We also have some exposure related to foreign currency fluctuations.

*Interest Rate Risk.* As of June 30, 2007, our only interest rate risk involved our line of credit with our principal lender and the \$1.0 million in notes payable to the former Partsbin stockholders. Although there were no borrowings outstanding under our line of credit at June 30, 2007, changes in the monthly LIBOR rate could affect the rates at which we could borrow funds under the line of credit. A 1% increase or decrease in LIBOR, however would result in an immaterial change in interest expense related to these outstanding borrowings.

*Foreign Currency Risk.* Our purchases of auto parts from our Asian suppliers are denominated in U.S. dollars, however a change in the foreign currency exchange rates could impact our product costs over time. While our operating expenses in the Philippines are generally paid in Philippine pesos, and Canadian website sales are denominated in Canadian dollars, fluctuations in currency rates have only had a nominal impact on our operations historically.

**ITEM 4. Controls and Procedures**

***Evaluation of Disclosure Controls and Procedures***

As of June 30, 2007, the end of the period covered by this periodic report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 and 15d-15 of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. Management recognizes that a control system, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within the Company have been detected. Therefore, assessing the costs and benefits of such controls and procedures necessarily involves the exercise of judgment by management. Our disclosure controls and procedures are designed to provide reasonable assurance of achieving the objective of ensuring that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms. In addition, our disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is accumulated and communicated to management, including our principal executive and principal financial officers or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

Our Chief Executive Officer and Chief Financial Officer have concluded, based on our evaluation of our disclosure controls and procedures, that our disclosure controls and procedures under Rule 13a-15(e) and Rule 15d-15(e) of the Exchange Act are ineffective. A material weakness, as defined in standards established by the Public Company Accounting Oversight Board (United States), has been identified. A material weakness is a deficiency in internal

control over financial reporting that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The identified material weakness consists of inadequate financial and accounting resources, our need to upgrade our accounting systems and improve our documentation of our key assumptions, estimates, accounting policies and procedures. We have also experienced certain deficiencies that we believe are related to our integration of Partsbin.

During the first quarter of this year, we began the implementation of remediation plans in order to eliminate the material weakness, including the following:

- We hired a Vice President of Finance, a General Counsel, a Manager of Finance, three Senior Accountants and a Senior Financial Analyst.
- Additional information systems personnel have been hired and system issues, including necessary alternatives, are being evaluated.
- We are preparing process documentation related to our key assumptions, estimates and accounting policies and procedures.

As of June 30, 2007, we believe that we have remediated the material weakness related to the lack of finance and accounting personnel. In addition, we have made significant progress in the area of documentation surrounding our accounting policies and procedures. We will continue to implement remediation plans to address the identified material weakness during the third and fourth quarters of this year.

#### ***Changes in Internal Control Over Financial Reporting***

Except as set forth above, we did not make any changes in our internal control over financial reporting during the three months ended June 30, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### ***Inherent Limitations on Internal Control***

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple errors or mistakes. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

## **PART II. Other Information**

### **ITEM 1.**

#### **Legal Proceedings**

The information set forth under Note 6 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item I of this Report, is incorporated herein by reference.

**ITEM 1A.**

**Risk Factors**

*Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described below in addition to the other cautionary statements and risks described elsewhere, and the other information contained, in this Report and in our other filings with the SEC, including our subsequent reports on Forms 10-K, 10-Q and 8-K, and any amendments thereto. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business. If any of these known or unknown risks or uncertainties actually occurs with material adverse effects on us, our business, financial condition, results of operations and/or liquidity could be seriously harmed. In that event, the market price for our common stock will likely decline and you may lose all or part of your investment.*

***Purchasers of aftermarket auto parts may not choose to shop online, which would prevent us from acquiring new customers who are necessary to the growth of our business.***

The online market for aftermarket auto parts is less developed than the online market for many other business and consumer products. Our success will depend in part on our ability to attract new customers and customers who have historically purchased auto parts through traditional retail and wholesale operations. Furthermore, we may have to incur significantly higher and more sustained advertising and marketing expenditures or price our products more competitively than we currently anticipate in order to attract additional online consumers and convert them into purchasing customers. Specific factors that could prevent prospective customers from purchasing from us include:

- concerns about buying auto parts without face-to-face interaction with sales personnel;
- the inability to physically handle, examine and compare products;
- delivery time associated with Internet orders;
- concerns about the security of online transactions and the privacy of personal information;
- delayed shipments or shipments of incorrect or damaged products; and
- the inconvenience associated with returning or exchanging items purchased online.

If the online market for auto parts does not gain widespread acceptance, our business and financial results may suffer.

***We depend on search engines and other online sources to attract visitors to our websites, and if we are unable to attract these visitors and convert them into customers in a cost-effective manner, our business and results of operations will be harmed.***

Our success depends on our ability to attract online consumers to our websites and convert them into customers in a cost-effective manner. We are significantly dependent upon search engines, shopping comparison sites and other online sources for our website traffic. We are included in search results as a result of both paid search listings, where we purchase specific search terms that will result in the inclusion of our listing, and algorithmic searches that depend upon the searchable content on our sites. Algorithmic listings cannot be purchased and instead are determined and displayed solely by a set of formulas utilized by the search engine. We rely on both algorithmic and purchased listings to attract and direct consumers to our websites. Search engines, shopping comparison sites and other online sources revise their algorithms from time to time in an attempt to optimize their search results. If one or more of the search engines, shopping comparison sites or other online sources on which we rely for website traffic were to modify its general methodology for how it displays our websites, resulting in fewer consumers clicking through to our websites, our financial results could be adversely affected. In particular, in February 2007, Yahoo! changed the manner in which it handles paid search listings to an approach similar to the one used by Google. This change makes it more difficult

for us to ascertain what other companies are bidding for specific key words. The adoption of this approach by Yahoo! and other paid search providers could significantly increase the cost of our Internet advertising. In addition, if any free search engine or shopping comparison site on which we rely begins charging fees for listing or placement, or if one or more of the search engines, shopping comparison sites and other online sources on which we rely for purchased listings, modifies or terminates its relationship with us, our expenses could rise, we could lose customers and traffic to our websites could decrease. In addition, our success in attracting visitors who convert to customers will depend in part upon our ability to identify and purchase relevant search terms, provide relevant content on our sites, and effectively target our other marketing programs such as e-mail campaigns and affiliate programs. If we are unable to attract visitors to our websites and convert them to customers in a cost-effective manner, then our business and financial results may be harmed.

***We are dependent upon relationships with suppliers in Taiwan, China and the United States for the vast majority of our products.***

We acquire substantially all of our products from manufacturers and distributors located in Taiwan, China and the United States. Our top ten suppliers represented approximately 64% of our total product purchases during the first six months of 2007. We do not have any long-term contracts or exclusive agreements with our foreign suppliers that would ensure our ability to acquire the types and quantities of products we desire at acceptable prices and in a timely manner. We have recently entered into supply agreements with our U.S. based suppliers and our primary drop-ship vendors. In addition, our ability to acquire products from our suppliers in amounts and on terms acceptable to us is dependent upon a number of factors that could affect our suppliers and which are beyond our control. For example, financial or operational difficulties that some of our suppliers may face may increase the cost of the products we purchase from them. In addition, the trend towards consolidation among auto parts suppliers may disrupt or end our relationship with some suppliers, and could lead to less competition and, consequently, higher prices.

In addition, because many of our suppliers are outside of the United States, additional factors could interrupt our relationships or affect our ability to acquire the necessary products on acceptable terms, including:

- political, social and economical instability and the risk of war or other international incidents in Asia;
- fluctuations in foreign currency exchange rates that may increase our cost of products;
- tariffs and protectionist laws and business practices that favor local businesses;
- difficulties in complying with import and export laws, regulatory requirements and restrictions; and
  - natural disasters and public health emergencies.

If we do not maintain our relationships with our existing suppliers or develop relationships with new suppliers on acceptable commercial terms, we may not be able to continue to offer a broad selection of merchandise at competitive prices and, as a result, we could lose customers and our sales could decline.

***Two class action lawsuits have been filed against us and certain of our officers and directors as well as a SEC informal inquiry into this matter, which could result in significant costs and a diversion of our management's efforts.***

We and certain of our officers and directors have been served with two complaints associated with class action lawsuits alleging violations of federal securities law in connection with our initial public offering. While we believe we have meritorious defenses and plan to defend vigorously any such claims made against us, we cannot assure you that these actions will be resolved without incurring significant costs and/or resulting in the diversion of the attention of management and other key employees. The resolution of this pending securities litigation and the defense of any

additional litigation that may arise could result in significant costs and any unfavorable outcome could have a material adverse effect on our business. In August 2007, we also received a letter from the SEC that indicated that the SEC had commenced an informal inquiry into the events leading up to the Company's announcement on March 20, 2007 of its financial results for the fourth quarter and year ended December 31, 2007. We intend to fully cooperate with the SEC in this matter. The preparation of any response in connection with SEC inquiry could result in significant costs that could have a material adverse effect on the business.

***Challenges by OEMs to the validity of aftermarket auto parts and claims of infringement could adversely affect our business and the viability of the aftermarket auto parts industry.***

Original equipment manufacturers have attempted to use claims of intellectual property infringement against manufacturers and distributors of aftermarket auto parts to restrict or eliminate the sale of aftermarket auto parts that are the subject of the claims. We have received in the past, and we anticipate we may in the future receive, communications alleging that certain products we sell infringe third-party patents, copyrights, trademarks and trade names or other intellectual property rights. For example, in December 2005, Ford Global Technologies, LLC filed a complaint with the United States International Trade Commission, or USITC, against us and five other named respondents, including four Taiwan-based manufacturers. Ford alleged in this action that we and the other respondents infringed 14 design patents (four of which were subsequently dropped from the investigation at Ford's request) that Ford claims cover eight parts for the 2004-2005 Ford F-150 truck. Ford asked the USITC to issue a permanent general exclusion order excluding from entry into the United States all auto parts that infringe the ten Ford design patents and that are imported into the United States, sold for importation in the United States, or sold within the United States after importation. Ford also sought a permanent order directing us and the other respondents to cease and desist from, among other things, selling, marketing, advertising, distributing and offering for sale imported auto parts that infringe the design patents. The administrative law judge issued an initial determination on December 4, 2006 finding three of the ten Ford Design Patents invalid, but upholding the validity and enforceability of the other seven Ford Design Patents. The judge further ruled that the importation of automotive parts allegedly covered by these seven patents violates Section 337 of the Tariff Act of 1930, as amended. This initial determination was subject to review by the USITC but became final upon notice by the USITC in March 2007 of its decision not to review the determination made by the administrative law judge.

On May 1, 2007, we and other respondents petitioned the USITC to reconsider its March 2007 ruling not to review the determination made by the ALJ regarding the seven Ford Design Patents found valid and infringed, in light of the Supreme Court's April 30, 2007 decision in *KSR International, Inc. v. Teleflex, Inc.* The USITC issued a "Notice of Commission Determination To Waive Reconsideration Rule Deadline And To Extend Target Date" on May 4, 2007. In this Notice, the USITC indicated that it would consider the petition and extended the target date for issuing a final order to June 6, 2007. On June 6, 2007, the USITC denied the petition for reconsideration, terminated its investigation and issued a general exclusion order. The commission denied Ford's request for a cease and desist order. The general exclusion order prohibits the importation, sale for importation, or sale in the United States after importation of aftermarket collision parts that infringe any of Ford's seven design patents previously determined to be valid. The final determination by the USITC was subject to review by the President of the United States, who is authorized to disapprove Commission orders for policy considerations. The mandatory 60-day Presidential review period, ended on August 6, 2007, with the President taking no action. We have sixty days from the expiration of the Presidential review period to file a petition for review with the United States Circuit Court of Appeals for the Federal Circuit. We intend to vigorously pursue our appellate rights.

While the portion of the Commission's March 20, 2007 ruling finding a violation of Section 337 did not become final appealable order until the end of the Presidential review period, the Commission's finding of no violation of Section 337 as to the three of Ford's Design Patents held invalid was not subject to Presidential review, and became a final appealable order as of March 20, 2007. Accordingly, on May 18, 2007, Ford filed a Petition For Review at the United States Court of Appeals for the Federal Circuit seeking review and reversal of the portion of the USITC's March 20, 2007 Final Determination finding three of the Ford Design Patents invalid. That appeal is currently pending.

To date, our sales of these parts have been minimal, but as the design for the 2004 model is incorporated into later year models of the F-150 and these trucks have been on the road longer, sales of aftermarket replacement parts for these trucks may increase substantially. Furthermore, if Ford continues to pursue, expands or escalates its claims against us, or if other OEMs commence similar actions, and any of them are successful in these actions, we could be restricted or prohibited from selling certain aftermarket products and the aftermarket auto parts industry could decline significantly, which could have a material adverse effect on our business, financial condition and results of operations.

Future infringement claims could also result in increased costs of doing business arising from increased legal expenses, adverse judgments or settlements or changes to our business practices required to settle such claims or satisfy any judgments. Litigation could result in interpretations of the law that require us to change our business practices or otherwise increase our costs and harm our business. We do not maintain insurance coverage to cover the types of claims that could be asserted. If a successful claim were brought against us, it could expose us to significant liability.

***Our integration of Partsbin has been time consuming and expensive and may not be successful in the long run, if at all.***

In May 2006, we completed the acquisition of Partsbin, an online retailer of aftermarket auto parts. As a result of the acquisition, we added 47 employees, and our available SKUs and net sales increased significantly. The acquisition of Partsbin has involved significant costs, has resulted in challenges integrating the diverse technologies used by each company and has placed, and may continue to place, pressures on our operational and financial infrastructure. We cannot assure you that our current cost structure or infrastructure will be adequate for the combined companies. To successfully integrate Partsbin, we anticipate that we will need to improve our operational and financial systems, procedures and controls and maintain our cost structure at appropriate levels.

The Partsbin acquisition also expanded our product offerings, particularly in the area of engine parts and performance parts and accessories, and significantly increased our use of drop-ship as a method of fulfillment. We cannot assure you that we can effectively manage this new fulfillment model or address the market for these additional auto parts.

The integration of Partsbin has, and may continue to, involve the consolidation of diverse business cultures, require substantial time and expenses, and distract management from other business matters. In addition, this acquisition includes significant intangible assets that are subject to periodic impairment testing which could result in substantial accounting charges. We have recently discovered some integration issues related to the Partsbin acquisition that were largely related to lower than expected order fill rates from drop-ship vendors in the fourth quarter of 2006 and lower pricing levels on our performance parts and accessories product category in the first quarter of 2007, which negatively impacted our gross margins during the first half of 2007. We cannot assure you that we will be able to adequately address these or other integration issues related to this acquisition. If we are unable to complete the integration of Partsbin in an efficient and timely manner, our business and operating results will be harmed.

***We rely on a single provider for the majority of our outsourced call center operations in the Philippines, and our net sales, profit margins and customer satisfaction may decline if this relationship is terminated.***

In connection with our acquisition of Partsbin, we expanded our outsourced call center operations in the Philippines and rely on a single provider for substantially all of such operations. In April 2007, we entered into a contract with such outsourced provider to transition many of their employees to us. This resulted in a payment by the Company to acquire this assembled workforce of approximately \$1.7 million. Under the terms of the agreement, approximately 182 of the provider's employees were given the opportunity to become U.S. Auto Parts employees. As of June 30, 2007, 171 of these employees had transitioned over to direct employment by our Philippines subsidiary. In addition, we have entered into an agreement to lease workstations in the provider's facility in the Philippines for a period of six months. We expect this transition will ultimately result in lower operating costs to us once complete, but we cannot



assure you that we will be able to transition the employees on a timely basis, or at a reasonable cost. Any delay or decline in service by this provider or the termination of this relationship could harm our reputation, result in a significant decline in our net sales and increase our operating expenses.

***We face intense competition and operate in an industry with limited barriers to entry, and some of our competitors may have greater resources than us and may be better positioned to capitalize on the growing e-commerce auto parts market.***

The auto parts industry is competitive and highly fragmented, with products distributed through multi-tiered and overlapping channels. We compete with both online and offline retailers who offer OEM and aftermarket auto parts to either the DIY or DIFM customer segments. Current or potential competitors include the following:

national auto parts retailers such as Advance Auto Parts, AutoZone, CSK Auto, Napa Auto Parts, O'Reilly Automotive and Pep Boys;

- large online marketplaces such as Amazon.com and eBay;
- local independent retailers or niche auto parts online retailers; and
- wholesale auto parts distributors such as Keystone Automotive and LKQ Corporation.

Barriers to entry are low, and current and new competitors can launch websites at a relatively low cost. Many of our current and potential offline competitors have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, marketing, technical, management and other resources than we do. In addition, some of our competitors have used and may continue to use aggressive pricing tactics and devote substantially more financial resources to website and system development than we do. We expect that competition will further intensify in the future as Internet use and online commerce continue to grow worldwide. Increased competition may result in reduced operating margins, reduced profitability, loss of market share and diminished brand recognition.

We would also experience significant competitive pressure if any of our suppliers were to sell their products directly to customers. Since our suppliers have access to merchandise at very low costs, they could sell products at lower prices and maintain higher gross margins on their product sales than we can. In this event, our current and potential customers may decide to purchase directly from these suppliers. Increased competition from any supplier capable of maintaining high sales volumes and acquiring products at lower prices than us could significantly reduce our market share and adversely impact our financial results.

***We rely on key personnel and may need additional personnel for the success and growth of our business.***

Our business is largely dependent on the personal efforts and abilities of key personnel including Mehran Nia, our Chief Executive Officer and President, Howard Tong, our Chief Operating Officer, and Michael McClane, our Chief Financial Officer, Executive Vice President of Finance, Treasurer and Secretary. Messrs. Nia, Tong and McClane, as well as any of our other key employees, can terminate their employment relationship with us at any time. We do not maintain key person life insurance on any officer or employee. Our performance also depends on our ability to identify, attract, retain and motivate highly skilled technical, managerial, merchandising, marketing and customer service personnel. Competition for such personnel is intense, and we cannot assure you that we will be successful in attracting and retaining such personnel. The loss of any key employee or our inability to attract or retain other qualified employees could harm our business and results of operations.

***If our product catalog database is stolen or misappropriated or if a competitor is able to create a substantially similar catalog without infringing our rights, then we may lose an important competitive advantage.***

We have invested significant resources and time to build and maintain our product catalog, which is maintained in the form of an electronic database, and maps SKUs to relevant product applications based on vehicle makes, models and years. We believe that our product catalog provides us with an important competitive advantage in both driving traffic to our websites and converting that traffic to revenue by enabling customers to quickly locate the products they require. We cannot assure you that we can protect our product catalog from unauthorized copying or theft by a third party. In addition, it is possible that a competitor could develop a catalog or database that is similar to or more comprehensive than ours, without infringing our rights. In the event our product catalog is stolen, copied or otherwise replicated by a competitor, whether lawfully or not, we may lose an important competitive advantage and our business could be harmed.

***Our future operating results may fluctuate and may fail to meet market expectations, which could adversely affect the market price of our common stock.***

We expect that our revenue and operating results will continue to fluctuate from quarter to quarter due to various factors, many of which are beyond our control. If our quarterly revenue or operating results fall below the expectations of investors or securities analysts, the price of our common stock could significantly decline. In March 2007, our stock price recently decreased by approximately 45% following our announcement that our financial results for the quarter ended December 31, 2006 did not meet analysts' expectations. The factors that could cause our operating results to continue to fluctuate include, but are not limited to:

- fluctuations in the demand for aftermarket auto parts;
- price competition on the Internet or among offline retailers for auto parts;
- our ability to attract visitors to our websites and convert those visitors into customers;
- our ability to maintain and expand our supplier and distribution relationships;
- the effects of seasonality on the demand for our products;

our ability to accurately forecast demand for our products, price our products at market rates and maintain appropriate inventory levels;

- our ability to build and maintain customer loyalty;
- the success of our brand-building and marketing campaigns;

government regulations related to use of the Internet for commerce, including the application of existing tax regulations to Internet commerce and changes in tax regulations;

- technical difficulties, system downtime or Internet brownouts; and

the amount and timing of operating costs and capital expenditures relating to expansion of our business, operations and infrastructure.

***Economic conditions may have an adverse effect on the demand for aftermarket auto parts and could adversely affect our sales and operating results.***

We sell aftermarket auto parts consisting of body and engine parts used for repair and maintenance, performance parts used to enhance performance or improve aesthetics and accessories that increase functionality or enhance a vehicle's

features. Demand for our products may be adversely affected by general economic conditions. In declining economies, consumers often defer regular vehicle maintenance and may forego purchases of nonessential performance products, which can result in a decrease in demand for auto parts in general. In expanding economies, consumers may be more likely to purchase new vehicles instead of repairing existing vehicles or they may be less price sensitive, leading to an increase in OEM parts sales at dealerships, either of which could also result in a decline in our sales. If such decreases in demand for our products are not offset by other factors, such as the deferral of new car purchases in declining economies, which may result in more required repairs for older vehicles, or the purchase of performance parts and accessories in expanding economies, our financial condition and results of operations would suffer.

***If we are unable to manage the challenges associated with our international operations, the growth of our business could be limited and our business could suffer.***

We maintain business operations in the United States and the Philippines and an outsourced call center in India. These international operations include development and maintenance of our websites, software development, enhancements of our online marketing technologies, and sales and customer support services. We also operate a Canadian subsidiary to facilitate sales in Canada. We are subject to a number of risks and challenges that specifically relate to our international operations. Our international operations may not be successful if we are unable to meet and overcome these challenges, which could limit the growth of our business and may have an adverse effect on our business and operating results. These risks and challenges include:

- difficulties and costs of staffing and managing foreign operations;
- restrictions imposed by local labor practices and laws on our business and operations;
- exposure to different business practices and legal standards;
  - unexpected changes in regulatory requirements;
  - the imposition of government controls and restrictions;
- political, social and economic instability and the risk of war, terrorist activities or other international incidents;
  - natural disasters and public health emergencies;
  - potentially adverse tax consequences;
- the failure of local laws to provide a sufficient degree of protection against infringement of our intellectual property; and
  - fluctuations in foreign currency exchange rates.

***If our fulfillment operations are interrupted for any significant period of time or are not sufficient to accommodate increased demand, our sales would decline and our reputation could be harmed.***

Our success depends on our ability to successfully receive and fulfill orders and to promptly deliver our products to our customers. The majority of orders for our body parts products are filled from our inventory in our distribution centers, where all our inventory management, packaging, labeling and product return processes are performed. Increased demand and other considerations may require us to expand our distribution centers or transfer our fulfillment operations to larger facilities in the future.

Our distribution centers are susceptible to damage or interruption from human error, fire, flood, power loss, telecommunications failures, terrorist attacks, acts of war, break-ins, earthquakes and similar events. We do not currently maintain back-up power systems at our fulfillment centers. We do not presently have a formal disaster recovery plan and our business interruption insurance may be insufficient to compensate us for losses that may occur in the event operations at our fulfillment center are interrupted. Any interruptions in our fulfillment operations for any significant period of time, including interruptions resulting from the expansion of our existing facilities or the transfer of operations to a new facility, could damage our reputation and brand and substantially harm our business and results of operations. In addition, if we do not successfully expand our fulfillment capabilities in response to increases in demand, we may not be able to substantially increase our net sales.

***We are dependent upon third parties for distribution and fulfillment operations with respect to many of our products.***

For a number of the products that we sell, we outsource the distribution and fulfillment operation and are dependent on our distributors to manage inventory, process orders and distribute those products to our customers in a timely manner. For the first six months of 2007, 11.6% of purchases were through a single supplier. Our agreement with this supplier may be terminated at any time by either party, with written notice and the appropriate notice period. If we do not maintain our existing relationships with our distributors on acceptable commercial terms, we will need to obtain other suppliers and may not be able to continue to offer a broad selection of merchandise at competitive prices, and our sales may decrease.

In addition, because we outsource to distributors a number of these traditional retail functions relating to those products, we have limited control over how and when orders are fulfilled. We also have limited control over the products that our distributors purchase or keep in stock. Our distributors may not accurately forecast the products that will be in high demand or they may allocate popular products to other resellers, resulting in the unavailability of certain products for sale on our websites. Any inability to offer a broad array of products at competitive prices and any failure to deliver those products to our customers in a timely and accurate manner may damage our reputation and brand and could cause us to lose customers.

***Our ability to sustain or increase our profitability will suffer if we fail to manage our growth effectively.***

In recent years, we have experienced rapid growth that has placed, and will continue to place, pressures on our operational and financial infrastructure. Our workforce has increased from 114 employees as of December 31, 2003 to 739 employees as of June 30, 2007. Our net sales have increased from \$31.7 million in 2003 to \$120.1 million in 2006 and to \$85.9 million for the six months ended June 30, 2007. Our recent expansion and planned growth have placed, and are expected to continue to place, a strain on our infrastructure, operations and managerial resources. We intend to further increase the size of our operations, and we expect our operating expenses to increase, as we, among other things:

- expand our domestic and international operations;
- increase our technology and development efforts to enhance and maintain our websites and technology infrastructure;
- hire additional personnel, including customer service specialists, sales and marketing professionals, and financial professionals;
- upgrade our operational and financial systems, procedures and controls; and
- assume the responsibilities and costs of being a public company.

Our success depends upon our ability to manage our operations and our growth effectively. To be successful, we will need to improve our operational and financial systems, procedures and controls, maintain our cost structure at appropriate levels, manage international operations, and hire additional personnel. We cannot assure you that our efforts will be successful or that we can improve our systems, procedures and controls in a timely manner. Delays or problems associated with any improvements or expansion of our systems, procedures and controls could harm our business and operating results. In addition, we may fail to accurately estimate and assess our increased operating expenses as we grow. As our operating expenses increase, we will need to grow our revenue in order to maintain and increase our profitability.

***If we fail to offer a broad selection of products and brands at competitive prices to meet our customers' demands, our revenue could decline.***

In order to expand our business, we must successfully offer, on a continuous basis, a broad selection of auto parts that meet the needs of our customers. Our auto parts are used by consumers for a variety of purposes, including repair, performance, improved aesthetics and functionality. In addition, to be successful, our product offerings must be broad and deep in scope, competitively priced, well-made, innovative and attractive to a wide range of consumers. We cannot predict with certainty that we will be successful in offering products that meet all of these requirements. If our product offerings fail to satisfy our customers' requirements or respond to changes in customer preferences, our revenue could decline.

***Future acquisitions could disrupt our business and harm our financial condition.***

As part of our growth strategy, we expect that we will selectively pursue acquisitions of businesses, technologies or services in order to expand our capabilities, enter new markets or increase our market share. Integrating any newly acquired businesses, technologies or services is likely to be expensive and time consuming. For example, our acquisition of Partsbin has resulted in significant costs and a number of challenges, including retaining employees of the acquired company, integrating our order processing and credit processing, integrating our product pricing strategy, and integrating the diverse technologies and differing e-commerce platforms and accounting systems used by each company. If we are unable to successfully complete this integration, we may not realize the synergies from the acquisition, and our business and results of operations could suffer. To finance any future acquisitions, it may also be necessary for us to raise additional capital through public or private financings. Additional funds may not be available on terms that are favorable to us, and, in the case of equity financings, would result in dilution to our stockholders. Future acquisitions by us could also result in large and immediate write-offs, assumption of debt and unforeseen liabilities and significant adverse accounting charges, any of which could substantially harm our business, financial condition and results of operations.

***We may be subject to liability for sales and other taxes and penalties, which could have an adverse effect on our business.***

We currently collect sales or other similar taxes only on the shipment of goods to the states of California, New Jersey and Tennessee. The U.S. Supreme Court has ruled that vendors whose only connection with customers in a state is by common carrier or the U.S. mail are free from state-imposed duties to collect sales and use taxes in that state. However, states could seek to impose additional income tax obligations or sales tax collection obligations on out-of-state companies such as ours, which engage in or facilitate online commerce, based on their interpretation of existing laws, including the Supreme Court ruling, or specific facts relating to us. If sales tax obligations are successfully imposed upon us by a state or other jurisdiction, we could be exposed to substantial tax liabilities for past sales and penalties and fines for failure to collect sales taxes. We could also suffer decreased sales in that state or jurisdiction as the effective cost of purchasing goods from us increases for those residing in that state or jurisdiction.

In addition, a number of states, as well as the U.S. Congress, have been considering various initiatives that could limit or supersede the Supreme Court's apparent position regarding sales and use taxes on Internet sales. If any of these

initiatives are enacted, we could be required to collect sales and use taxes in additional states and our revenue could be adversely affected. Furthermore, the U.S. Congress has not yet extended a moratorium, which was first imposed in 1998 but has since expired, on state and local governments' ability to impose new taxes on Internet access and Internet transactions. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us as well as substantially impair the growth of e-commerce and adversely affect our revenue and profitability. Since our service is available over the Internet in multiple states, these jurisdictions may require us to qualify to do business in these states. If we fail to qualify in a jurisdiction that requires us to do so, we could face liabilities for taxes and penalties.

***We could be liable for breaches of security on our websites.***

A fundamental requirement for e-commerce is the secure transmission of confidential information over public networks. Anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. Although we have developed systems and processes that are designed to protect consumer information and prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches may adversely affect our operating results. We may be required to expend significant capital and other resources to protect against potential security breaches or to alleviate problems caused by any breach. We rely on licensed encryption and authentication technology to provide the security and authentication necessary for secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments may result in a compromise or breach of the algorithms that we use to protect customer transaction data. In the event someone circumvents our security measures, it could seriously harm our business and reputation and we could lose customers. Security breaches could also expose us to a risk of loss or litigation and possible liability for failing to secure confidential customer information.

***The success of our business depends on the continued growth of the Internet as a retail marketplace and the related expansion of the Internet infrastructure.***

Our future success depends upon the continued and widespread acceptance and adoption of the Internet as a vehicle to purchase products. If customers or manufacturers are unwilling to use the Internet to conduct business and exchange information, our business will fail. The commercial acceptance and use of the Internet may not continue to develop at historical rates, or may not develop as quickly as we expect. The growth of the Internet, and in turn the growth of our business, may be inhibited by concerns over privacy and security, including concerns regarding "viruses" and "worms," reliability issues arising from outages or damage to Internet infrastructure, delays in development or adoption of new standards and protocols to handle the demands of increased Internet activity, decreased accessibility, increased government regulation, and taxation of Internet activity. In addition, our business growth may be adversely affected if the Internet infrastructure does not keep pace with the growing Internet activity and is unable to support the demands placed upon it, or if there is any delay in the development of enabling technologies and performance improvements.

***If we do not respond to technological change, our websites could become obsolete and our financial results and conditions could be adversely affected.***

We maintain a network of websites which requires substantial development and maintenance efforts and entails significant technical and business risks. To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our websites. The Internet and the e-commerce industry are characterized by rapid technological change, the emergence of new industry standards and practices and changes in customer requirements and preferences. Therefore, we may be required to license emerging technologies, enhance our existing websites, develop new services and technology that address the increasingly sophisticated and varied needs of our current and prospective customers, and adapt to technological advances and emerging industry and regulatory standards and practices in a cost-effective and timely manner. Our ability to remain technologically competitive may require substantial expenditures and lead time and our failure to do so may harm our business and results of

operations.

***System failures, including failures due to natural disasters or other catastrophic events, could prevent access to our websites, which could reduce our net sales and harm our reputation.***

Our sales would decline and we could lose existing or potential customers if they are not able to access our websites or if our websites, transaction processing systems or network infrastructure do not perform to our customers' satisfaction. Any Internet network interruptions or problems with our websites could:

- prevent customers from accessing our websites;
- reduce our ability to fulfill orders or bill customers;
- reduce the number of products that we sell;
  - cause customer dissatisfaction; or
  - damage our brand and reputation.

We have experienced brief computer system interruptions in the past, and we believe they will continue to occur from time to time in the future. Our systems and operations are also vulnerable to damage or interruption from a number of sources, including a natural disaster or other catastrophic event such as an earthquake, typhoon, volcanic eruption, fire, flood, terrorist attack, power loss, telecommunications failure, physical and electronic break-ins and other similar events. For example, our headquarters and the majority of our infrastructure, including some of our servers, are located in Southern California, a seismically active region. We also maintain offshore and outsourced operations in the Philippines, an area that was recently subjected to a typhoon and a volcanic eruption. In addition, California has in the past experienced power outages as a result of limited electrical power supplies. Such outages, natural disasters and similar events may recur in the future and could disrupt the operation of our business. Our technology infrastructure is also vulnerable to computer viruses, physical or electronic break-ins and similar disruptions. Although the critical portions of our systems are redundant and backup copies are maintained offsite, not all of our systems and data are fully redundant. We do not presently have a formal disaster recovery plan in effect and may not have sufficient insurance for losses that may occur from natural disasters or catastrophic events. Any substantial disruption of our technology infrastructure could cause interruptions or delays in our business and loss of data or render us unable to accept and fulfill customer orders or operate our websites in a timely manner, or at all.

***Capacity constraints on our technology infrastructure would harm our business, prospects, results of operations and financial condition.***

If the volume of traffic on our websites or the number of purchases made by customers increases substantially, we may need to further expand and upgrade our technology, transaction processing systems and network infrastructure. Capacity constraints can cause unanticipated system disruptions, slower response times, degradation in levels of customer service, impaired quality and delays in reporting accurate financial information.

We may be unable to project accurately the rate or timing of traffic increases or successfully and cost-effectively upgrade our systems and infrastructure in time to accommodate future traffic levels on our websites. Any such upgrades to our systems and infrastructure will require substantial expenditures. In addition, we may be unable to upgrade and expand our transaction processing systems in an effective and timely manner or to integrate any newly developed or purchased functionality with our existing systems. Any inability to efficiently upgrade our systems and infrastructure in a timely manner to account for such growth and integrations may cause unanticipated system disruptions, slower response times, degradation in levels of customer service, impaired quality, delayed order fulfillment, any of which could result in a decline in our sales and harm our reputation.

***We depend on third-party delivery services to deliver our products to our customers on a timely and consistent basis, and any deterioration in our relationship with any one of these third parties or increases in the fees that they charge could adversely affect our business and financial condition.***

We rely on third parties for the shipment of our products and we cannot be sure that these relationships will continue on terms favorable to us, or at all. Increases in shipping costs could harm our business, prospects, financial condition and results of operations by increasing our costs of doing business and resulting in reduced gross margins. Our average cost per shipment with our primary carrier increased in January 2007. In addition, if our relationships with these third parties are terminated or impaired, or if these third parties are unable to deliver products for us, whether through labor shortage, slow down or stoppage, deteriorating financial or business condition, responses to terrorist attacks or for any other reason, we would be required to use alternative carriers for the shipment of products to our customers. Changing carriers could have a negative effect on our business and operating results due to reduced visibility of order status and package tracking and delays in order processing and product delivery, and we may be unable to engage alternative carriers on a timely basis, upon terms favorable to us, or at all.

***We face exposure to product liability lawsuits.***

The automotive industry in general has been subject to a large number of product liability claims due to the nature of personal injuries that result from car accidents or malfunctions. As a distributor of auto parts, we could be held liable for the injury or damage caused if the products we sell are defective or malfunction. While we carry insurance against product liability claims, if the damages in any given action were high or we were subject to multiple lawsuits, the damages and costs could exceed the limits of our insurance coverage. If we were required to pay substantial damages as a result of these lawsuits, it may seriously harm our business and financial condition. Even defending against unsuccessful claims could cause us to incur significant expenses and result in a diversion of management's attention. In addition, even if the money damages themselves did not cause substantial harm to our business, the damage to our reputation and the brands offered on our websites could adversely affect our future reputation and our brand, and could result in a decline in our net sales and profitability.

***If we fail to maintain an effective system of internal control over financial reporting or are not able to adequately address certain identified material weaknesses in our system of internal controls or comply with Section 404 of the Sarbanes-Oxley Act of 2002, we may not be able to accurately report our financial results or prevent fraud, and our stock price could decline.***

Our auditors have identified certain material weaknesses in our system of internal control over financial reporting that are primarily related to our need to hire additional financial and accounting employees, as well as our need to upgrade our accounting systems and improve our documentation of our key assumptions, estimates, accounting policies and procedures. We have also experienced certain deficiencies that we believe are related to our integration of Partsbin, including the credit processing and pricing functions. If we fail to adequately address these material weaknesses and are not able to staff our accounting and finance department with the appropriate complement of experienced employees, we may not be able to improve our system of internal control over financial reporting to comply with the reporting requirements applicable to public companies in the United States. Furthermore, it is possible that we or our auditors will identify additional material weaknesses or significant deficiencies in the future in our system of internal control over financial reporting. Our failure to address any deficiencies or weaknesses in our internal control over financial reporting or to properly maintain an effective system of internal control over financial reporting could impact our ability to prevent fraud or to issue our financial statements in a timely manner that presents fairly our financial condition and results of operations. The existence of any such deficiencies or weaknesses, even if cured, may also lead to the loss of investor confidence in the reliability of our financial statements, could harm our business and negatively impact the trading price of our common stock. Such deficiencies or material weaknesses may also subject us to lawsuits, investigations and other penalties.



In addition, Section 404 of the Sarbanes-Oxley Act of 2002 will require us to evaluate and report on our internal control over financial reporting beginning with our Annual Report on Form 10-K for the year ending December 31, 2007, and have our independent auditors attest to our evaluation, beginning with our Annual Report on Form 10-K for the year ending December 31, 2008. We have prepared an internal plan of action for compliance with Section 404 and for strengthening and testing our system of internal control to provide the basis for our report, but we cannot assure you that this plan of action will be sufficient to meet the rigorous requirements of Section 404, and our independent auditors may issue an adverse opinion regarding management's assessment of Section 404 compliance. Our failure to comply with Section 404 or our reporting requirements would reduce investors' confidence in our financial statements and harm our stock price and could subject us to a variety of administrative sanctions, including the suspension or delisting of our common stock from the NASDAQ Global Market and the inability of registered broker/dealers to make a market in our common stock, which could also reduce our stock price.

***Existing or future government regulation could expose us to liabilities and costly changes in our business operations and could reduce customer demand for our products and services.***

We are subject to federal and state consumer protection laws and regulations, including laws protecting the privacy of customer non-public information and regulations prohibiting unfair and deceptive trade practices, as well as laws and regulations governing businesses in general and the Internet and e-commerce. Additional laws and regulations may be adopted with respect to the Internet, the effect of which on e-commerce is uncertain. These laws may cover issues such as user privacy, spyware and the tracking of consumer activities, marketing e-mails and communications, other advertising and promotional practices, money transfers, pricing, content and quality of products and services, taxation, electronic contracts and other communications, intellectual property rights, and information security. Furthermore, it is not clear how existing laws such as those governing issues such as property ownership, sales and other taxes, trespass, data mining and collection, and personal privacy apply to the Internet and e-commerce. To the extent we expand into international markets, we will be faced with complying with local laws and regulations, some of which may be materially different than U.S. laws and regulations. Any such foreign law or regulation, any new U.S. law or regulation, or the interpretation or application of existing laws and regulations to the Internet or other online services, may have a material adverse effect on our business, prospects, financial condition and results of operations by, among other things, impeding the growth of the Internet, subjecting us to fines, penalties, damages or other liabilities, requiring costly changes in our business operations and practices, and reducing customer demand for our products and services. We do not maintain insurance coverage to cover the types of claims or liabilities that could arise as a result of such regulation.

***If we are unable to protect our intellectual property rights, our reputation and brand could be impaired and we could lose customers.***

We regard our trademarks, trade secrets and similar intellectual property as important to our success. We rely on trademark and copyright law, and trade secret protection, and confidentiality and/or license agreements with employees, customers, partners and others to protect our proprietary rights. We cannot be certain that we have taken adequate steps to protect our proprietary rights, especially in countries where the laws may not protect our rights as fully as in the United States. In addition, third parties may infringe or misappropriate our proprietary rights, and we could be required to incur significant expenses to preserve them. We have common law trademarks, as well as pending federal trademark registrations for several marks. Even if we obtain approval of such pending registrations, the resulting registrations may not adequately cover our inventions or protect us against infringement by others. Effective trademark, service mark, copyright, patent and trade secret protection may not be available in every country in which our products and services may be made available online. We also currently own or control a number of Internet domain names, including [www.usautoparts.net](http://www.usautoparts.net), [www.partstrain.com](http://www.partstrain.com) and [www.autopartswarehouse.com](http://www.autopartswarehouse.com). We may be unable to protect these domain names or acquire or maintain relevant domain names in the United States and in other countries. If we are not able to protect our trademarks, domain names or other intellectual property, we may experience difficulties in achieving and maintaining brand recognition and customer loyalty.

***Our e-commerce system is dependent on open-source software, which exposes us to uncertainty and potential liability.***

We utilize open-source software such as Linux, Apache, MySQL, PHP, Fedora and Perl throughout our web properties and supporting infrastructure. Open-source software is maintained and upgraded by a general community of software developers under various open-source licenses, including the GNU General Public License, or GPL. These developers are under no obligation to maintain, enhance or provide any fixes or updates to this software in the future. Additionally, under the terms of the GPL and other open-source licenses, we may be forced to release to the public source-code internally developed by us pursuant to such licenses. Furthermore, if any of these developers contribute any code of others to any of the software that we use, we may be exposed to claims and liability for intellectual property infringement. A number of lawsuits are currently pending against third parties over the ownership rights to the various components within some open-source software that we use. If the outcome of these lawsuits is unfavorable, we may be held liable for intellectual property infringement based on our use of these open-source software components. We may also be forced to implement changes to the code-base for this software or replace this software with internally developed or commercially licensed software.

***We rely on bandwidth and data center providers and other third parties to provide products to our customers, and any failure or interruption in the services provided by these third parties could disrupt our business and cause us to lose customers.***

We rely on third-party vendors, including data center and bandwidth providers. Any disruption in the network access or co-location services, which are the services that house and provide Internet access to our servers, provided by these third-party providers or any failure of these third-party providers to handle current or higher volumes of use could significantly harm our business. Any financial or other difficulties our providers face may have negative effects on our business, the nature and extent of which we cannot predict. We exercise little control over these third-party vendors, which increases our vulnerability to problems with the services they provide. We also license technology and related databases from third parties to facilitate elements of our e-commerce platform. We have experienced and expect to continue to experience interruptions and delays in service and availability for these elements. Any errors, failures, interruptions or delays experienced in connection with these third-party technologies could negatively impact our relationship with our customers and adversely affect our business.

Our systems also heavily depend on the availability of electricity, which also comes from third-party providers. If we were to experience a major power outage, we would have to rely on back-up generators. These back-up generators may not operate properly through a major power outage, and their fuel supply could also be inadequate during a major power outage. Information systems such as ours may be disrupted by even brief power outages, or by the fluctuations in power resulting from switches to and from backup generators. This could disrupt our business and cause us to lose customers.

***The United States government may substantially increase border controls and impose restrictions on cross-border commerce that may substantially harm our business.***

We purchase a substantial portion of our products from foreign manufacturers and other suppliers who source products internationally. Restrictions on shipping goods into the United States from other countries pose a substantial risk to our business. Particularly since the terrorist attacks on September 11, 2001, the United States government has substantially increased border surveillance and controls. If the United States were to impose further border controls and restrictions, impose quotas, tariffs or import duties, increase the documentation requirements applicable to cross border shipments or take other actions that have the effect of restricting the flow of goods from other countries to the United States, we may have greater difficulty acquiring our inventory in a timely manner, experience shipping delays, or incur increased costs and expenses, all of which would substantially harm our business and results of operations.

***Our stock price has been and may continue to be volatile, which may result in losses to our stockholders.***

The market prices of technology and e-commerce companies generally have been extremely volatile and have recently experienced sharp share price and trading volume changes. The trading price of our common stock is likely to be volatile and could fluctuate widely in response to, among other things, the risk factors described in this report and other factors beyond our control such as fluctuations in the operations or valuations of companies perceived by investors to be comparable to us, our ability to meet analysts' expectations, or conditions or trends in the Internet or auto parts industries.

Since the completion of our initial public offering in February 2007, the trading price of our common stock has been volatile, declining from a high closing sales price of \$12.49 per share to a low closing sales price per share of \$5.12. We have also experienced significant fluctuations in the trading volume of our common stock. General economic and political conditions unrelated to our performance, may also adversely affect the price of our common stock. In the past, following periods of volatility in the market price of a public company's securities, securities class action litigation has often been initiated. Recently, we and certain of our officers and directors have been served with three complaints associated with a class action lawsuit alleging violations of federal securities law in connection with our initial public offering, which could subject us to significant costs and liability.

***Our executive officers and directors own a significant percentage of our stock.***

As of the closing of our initial public offering in February 2007, our executive officers and directors and entities that are affiliated with them beneficially owned approximately 57.2% of our outstanding shares of common stock. This significant concentration of share ownership may adversely affect the trading price for our common stock because investors often perceive disadvantages in owning stock in companies with controlling stockholders. Also, these stockholders, acting together, will be able to control our management and affairs and matters requiring stockholder approval including the election of our entire board of directors and certain significant corporate actions such as mergers, consolidations or the sale of substantially all of our assets. As a result, this concentration of ownership could delay, defer or prevent others from initiating a potential merger, takeover or other change in our control, even if these actions would benefit our other stockholders and us.

***A large number of additional shares may be sold into the public market in the near future, which may cause the market price of our common stock to decline significantly, even if our business is doing well.***

Sales of a substantial amount of common stock in the public market, or the perception that these sales may occur, could adversely affect the market price of our common stock. As of the closing of our initial public offering in February 2007, we had 29,832,927 shares of common stock outstanding, of which the 11,500,000 shares we and the selling stockholders sold in such offering may be resold in the public market immediately. The remaining outstanding shares are all subject to lock-up agreements with the underwriters for our initial public offering and with us. Pursuant to such agreements, of these remaining shares, 6,649,618 shares will become available for resale in the public market 12 months after the date of effectiveness of the registration statement filed with respect to such offering and 11,683,309 shares will become available for resale in the public market 18 months after such date. However, we and the underwriters can waive the lock-up restriction and allow these stockholders to sell their shares at any time, subject to applicable securities law and limitations. As restrictions on resale end, the market price could drop significantly if the holders of these restricted shares sell them or are perceived by the market as intending to sell them.

***We will incur increased costs and compliance risks as a result of being a public company.***

We completed our initial public offering in February 2007. As a public company, we expect to incur significant legal, accounting and other expenses that we did not incur as a private company. These expenses are associated with our public company reporting requirements and certain corporate governance requirements, including requirements under the Sarbanes-Oxley Act of 2002 and the new rules implemented by the SEC and the NASDAQ Stock Market. We expect that compliance with these rules and regulations, in particular Section 404 of the Sarbanes-Oxley Act of 2002,

will substantially increase our legal and financial compliance costs and will likely require us to hire additional personnel and/or consultants. Like many smaller public companies, we expect to face a significant impact from required compliance with Section 404 of the Sarbanes-Oxley Act of 2002. The process of strengthening our internal control and complying with Section 404 will be expensive and time consuming, and will require significant time and attention from our management team. We are currently evaluating and monitoring developments with respect to these new rules, and we cannot predict or estimate the amount of additional costs we may incur or the timing of such costs.

We also expect these new rules and regulations may make it more difficult and more expensive for us to obtain director and officer liability insurance and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified individuals to serve on our board of directors or as executive officers.

*We do not intend to pay dividends on our common stock.*

We currently intend to retain any future earnings and do not expect to pay any cash dividends on our capital stock for the foreseeable future.

*Our charter documents could deter a takeover effort, which could inhibit your ability to receive an acquisition premium for your shares.*

Provisions in our certificate of incorporation and bylaws could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders. Such provisions include the following:

• our board of directors are authorized, without prior stockholder approval, to create and issue preferred stock which could be used to implement anti-takeover devices;

• advance notice is required for director nominations or for proposals that can be acted upon at stockholder meetings;

• our board of directors is classified such that not all members of our board are elected at one time, which may make it more difficult for a person who acquires control of a majority of our outstanding voting stock to replace all or a majority of our directors;

• stockholder action by written consent is prohibited except with regards to an action that has been approved by the board;

• special meetings of the stockholders are permitted to be called only by the chairman of our board of directors, our chief executive officer or by a majority of our board of directors;

- stockholders are not be permitted to cumulate their votes for the election of directors; and

• stockholders are permitted to amend certain provisions of our bylaws only upon receiving at least 66 2/3% of the votes entitled to be cast by holders of all outstanding shares then entitled to vote generally in the election of directors, voting together as a single class.

## **ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

### **Sales of Unregistered Securities**

None.

### **Use of Proceeds from Sales of Registered Securities**

On February 14, 2007, we completed the initial public offering of our common stock, pursuant to which we sold 8,000,000 shares of our common stock and the selling stockholders sold an aggregate of 3,500,000 shares of our common stock (which included 1,500,000 shares sold by the selling stockholders pursuant to the exercise of the underwriters' over-allotment option) at the initial public offering price of \$10.00 per share. The shares of common stock sold in the offering were registered under the Securities Act on a registration statement on Form S-1 (File No. 333-138379) that was declared effective by the SEC on February 8, 2007.

The aggregate purchase price of the shares sold by us in the offering was \$80.0 million. The aggregate purchase price of the shares sold by the selling stockholders was \$35.0 million. We and the selling stockholders paid to the underwriters underwriting discounts and commissions totaling \$5.6 million and \$2.5 million, respectively, in connection with the offering. In addition, we incurred offering costs of approximately \$2.9 million in connection with the offering. After deducting the underwriting discounts and commissions and offering expenses, we received net proceeds from the offering of approximately \$71.5 million. We did not receive any proceeds from the sale of shares by the selling stockholders.

Approximately \$28.0 million of the net proceeds from the offering was used to repay our outstanding indebtedness under two term loans for approximately \$18.0 million and \$10.0 million, payable to our commercial lender. In addition, \$4.0 million of the net proceeds from the offering has been paid on the notes payable to the former stockholders of Partsbin, including Richard Pine, one of our directors and who is also an officer. Except for the payment of such debt, none of the net proceeds from the offering were paid directly or indirectly to any of our directors or officers (or their associates) or persons owning ten percent or more of any class of our equity securities or to any other affiliate, other than in the form of wages or salaries and bonuses paid out in the ordinary course of business. The remaining net proceeds from the offering have been invested in money market accounts. We will retain broad discretion over the use of the net proceeds received from our initial public offering. The amount and timing of our actual expenditures may vary significantly depending on a number of factors, including the growth of our sales and customer base, the type of efforts we make to build our brand and competitive developments in e-commerce. For the period ending June 30, 2007 we did not make any business acquisition that would require use of such proceeds.

**ITEM 3. Defaults Upon Senior Securities.**

None.

**ITEM 4. Submission of Matters to a Vote of Security Holders**

Our Annual Meeting of Stockholders was held on June 22, 2007. The following two items were voted on and approved at the Annual Meeting:

- (i) Election of two Class 1 directors to hold office for the term of three years or until their respective successor is elected and qualified. The nominees for election were:

<b>Nominee</b>	<b>Votes</b>	
	<b>Votes For</b>	<b>Withheld</b>
Mehran Nia	27,088,826	1,146,526
Ellen F. Siminoff	28,116,738	118,616

The Company's directors whose terms continued after the Annual Meeting are:

- Robert J. Majteles
- Sol Khazani
- Fredric W. Harman
- Richard Pine

- (ii) Ratify the appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2007.

	<b>Votes</b>
For	28,208,353
Against	26,001
Abstain	1,000
Broker Non-Votes	—

**ITEM 5. Other Information**

None.

**ITEM 6. Exhibits**

- (a) Exhibits

The following exhibits are filed herewith.

**Exhibit Description  
No.**

- 10.1 Lease Agreements, dated August 8, 2007, by and among MBS Tek Corporation and Roshan Commercial Corp.
- 10.2 Form of Suppliers' Agreement entered into between U.S. Auto Parts Network, Inc. and certain of its U.S. based suppliers and primary drop-ship vendors

- 31.1 Certification of the principal executive officer required by Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as amended
- 31.2 Certification of the principal financial officer required by Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as amended
- 32.1 Certification of the Chief Executive Officer required by 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Chief Financial Officer required by 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**SIGNATURES**

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

Dated: August 14, 2007

U.S. AUTO PARTS NETWORK, INC.  
(Registrant)

By /s/ MEHRAN NIA  
Mehran Nia,  
President and Chief Executive Officer  
(Principal Executive Officer)

By /s/ MICHAEL J. McCLANE  
Michael J. McClane,  
Chief Financial Officer  
(Principal Accounting Officer)



## EXHIBIT INDEX

### Exhibit Description

#### No.

- 10.1 Lease Agreements, dated August 8, 2007, by and among MBS Tek Corporation and Roshan Commercial Corp.
- 10.2 Form of Suppliers' Agreement entered into between U.S. Auto Parts Network, Inc. and certain of its U.S. based suppliers and primary drop-ship vendors
- 31.1 Certification of the principal executive officer required by Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as amended
- 31.2 Certification of the principal financial officer required by Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as amended
- 32.1 Certification of the Chief Executive Officer required by 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of the Chief Financial Officer required by 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002