

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 1998

Commission file number 1-13293

SunSource Inc.

-----  
(Exact name of registrant as specified in its charter)

Delaware

23-2874736

-----  
(State or other jurisdiction of  
incorporation or organization)

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

3000 One Logan Square  
Philadelphia, Pennsylvania

19103

-----  
(Address of principal executive offices)

-----  
(Zip Code)

Registrant's telephone number, including area code: (215) 282-1290

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of Each Exchange on Which Registered
----- Common Stock, par value \$.01 per share	----- New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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    X        NO  
-----    -----

On November 16, 1998 there were 6,809,063 Common Shares outstanding.

## Item 1. Consolidated Financial Statements

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SUNSOURCE INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(dollars in thousands)

<TABLE>  
<CAPTION>

September 30, 1997 (Unaudited)	ASSETS	September 30, 1998 (Unaudited)	December 31, 1997	
-----		-----	-----	---
Current assets:				
<S>		<C>	<C>	<C>
Cash and cash equivalents		\$ 10,174	\$ 5,638	\$
2,674				
Accounts and notes receivable, net		101,557	82,501	
90,923				
Inventories		102,710	103,369	
99,872				
Deferred income taxes		10,593	10,791	
11,402				
Other current assets		3,649	4,559	
4,236		-----	-----	---
-----				
Total current assets		228,683	206,858	
209,107				
Property and equipment, net		24,642	21,939	
21,285				
Goodwill		74,541	62,588	
63,118				
Other intangibles		918	784	
886				
Deferred income taxes		5,146	5,014	

4,471			
Cash surrender value of life insurance policies	8,823	8,407	
5,535			
Other assets	1,034	552	
601			
-----	-----	-----	---
Total assets	\$ 343,787	\$ 306,142	\$
305,003			
=====	=====	=====	
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)			
Current liabilities:			
Accounts payable, trade	\$ 55,008	\$ 50,125	\$
55,385			
Notes payable	974	2,080	
1,099			
Current portion of capitalized lease obligations	276	156	
135			
Dividends / distributions payable	726	2,995	
17,557			
Deferred tax liability	1,322	935	
--			
Accrued expenses:			
Salaries and wages	7,294	6,891	
6,393			
Income and other taxes	3,087	4,286	
4,617			
Other accrued expenses	22,092	18,452	
18,564			
-----	-----	-----	---
Total current liabilities	90,779	85,920	
103,750			
Senior notes	60,000	60,000	
60,000			
Bank revolving credit	46,000	33,000	
17,000			
Capitalized lease obligations	626	572	
573			
Deferred compensation	10,256	10,451	
9,994			
Other liabilities	704	787	
792			
-----	-----	-----	---
Total liabilities	208,365	190,730	
192,109			
-----	-----	-----	---
Guaranteed preferred beneficial interests in the Company's junior subordinated debentures	115,639	115,903	
115,991			
-----	-----	-----	---
Commitments and contingencies			
Stockholders' equity (deficit):			
Preferred stock, \$.01 par, 1,000,000 shares authorized, none issued	--	--	
--			
Common stock, \$.01 par, 20,000,000 shares authorized, 7,216,199, 6,418,936 and 6,418,936 shares issued	72	64	
64			
Additional paid-in capital	21,081	--	
--			
Retained earnings (accumulated deficit)	10,393	1,735	
(1,485)			
Unearned compensation	(244)	--	
--			
Accumulated other comprehensive income	(5,020)	(2,290)	
(1,676)			
Treasury stock, at cost, 366,400 shares in 1998, none in 1997	(6,499)	--	
--			
-----	-----	-----	---
Total stockholders' equity (deficit)	19,783	(491)	
(3,097)			
-----	-----	-----	---

Total liabilities and stockholders' equity (deficit)	\$ 343,787	\$ 306,142	\$
305,003	=====	=====	

=====

</TABLE>

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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SUNSOURCE INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)  
FOR THE THREE MONTHS ENDED,  
(dollars in thousands, except for per share amounts)

	September 30, 1998	September 30, 1997
	-----	-----
Net sales	\$ 184,845	\$ 178,540
Cost of sales	107,942	105,749
	-----	-----
Gross profit	76,903	72,791
	-----	-----
Operating expenses:		
Selling, general and administrative expenses	63,183	59,517
Management fee to general partner	--	840
Depreciation	1,259	1,006
Amortization	576	452
	-----	-----
Total operating expenses	65,018	61,815
	-----	-----
Transaction costs	--	2,428
Litigation costs - divested operations	1,600	--
	-----	-----
Income from operations	10,285	8,548
Interest expense, net	1,752	1,772
Distributions on guaranteed preferred beneficial interests	3,058	--
Other income (expense), net	100	(63)
	-----	-----
Income before provision for income taxes	5,575	6,713
Income tax provision (benefit)	1,025	(8,960)
	-----	-----
Income before extraordinary loss	4,550	15,673
Extraordinary loss from early extinguishment of debt, net of deferred income tax benefit of \$951	--	(3,392)
	-----	-----
Net income	\$ 4,550	\$ 12,281
	=====	=====
Net income per common share	\$ 0.64	N/A
Pro forma net income per common share (note 1)	N/A	\$ 0.56
Weighted average number of outstanding common shares	7,120,576	N/A

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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SUNSOURCE INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)  
FOR THE NINE MONTHS ENDED,

(dollars in thousands, except for per share amounts)

	September 30, 1998	September 30, 1997
	-----	-----
Net sales	\$ 547,138	\$ 529,199
Cost of sales	324,931	315,000
	-----	-----
Gross profit	222,207	214,199
	-----	-----
Operating expenses:		
Selling, general and administrative expenses	184,548	178,173
Management fee to general partner	--	2,491
Depreciation	3,541	3,024
Amortization	1,645	1,358
	-----	-----
Total operating expenses	189,734	185,046
	-----	-----
Transaction costs	--	3,053
Litigation costs - divested operations	1,600	--
	-----	-----
Income from operations	30,873	26,100
Interest expense, net	5,086	5,507
Distributions on guaranteed preferred beneficial interests	9,174	--
Other income (expense), net	301	(83)
	-----	-----
Income before provision for income taxes	16,914	20,510
Income tax provision (benefit)	6,128	(8,932)
	-----	-----
Income before extraordinary loss	10,786	29,442
Extraordinary loss from early extinguishment of debt, net of deferred income tax benefit of \$951	--	(3,392)
	-----	-----
Net income	\$ 10,786	\$ 26,050
	=====	=====
Net income per common share	\$ 1.55	N/A
Pro forma net income per common share (note 1)	N/A	\$ 1.35
Weighted average number of outstanding common shares	6,939,106	N/A

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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SUNSOURCE INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
FOR THE THREE MONTHS ENDED,  
(dollars in thousands)

<TABLE>  
<CAPTION>

	September 30, 1998	September 30, 1997
	-----	-----
Cash flows from operating activities:		
<S> Net income	<C> \$ 4,550	<C> \$ 12,281
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,835	1,458
Extraordinary loss	--	4,343
Decrease (increase) in cash value of life insurance	1,300	(325)

Transaction costs	--	2,428
Provision for deferred compensation	--	561
Deferred income tax benefit	(361)	(10,206)
Changes in current operating items, net of businesses acquired:		
Increase (decrease) in accounts and notes receivable	(2,937)	4,135
Decrease in inventories	2,477	1,697
Decrease in other current assets	315	465
Increase (decrease) in accounts payable	(2,764)	2,020
Decrease in accrued interest	--	(460)
Increase in income taxes payable	7	56
Decrease in accrued restructuring charges and transaction costs	(115)	(1,834)
Increase in other accrued liabilities	5,593	1,390
Other items, net	(3,096)	(1,087)
	-----	-----
Net cash provided by operating activities	6,804	16,922
	-----	-----
Cash flows from investing activities:		
Proceeds from sale of property and equipment	177	265
Payments for acquired businesses, net of cash acquired	(6,488)	(704)
Capital expenditures	(1,526)	(1,210)
Investment in life insurance policies	--	(316)
Other, net	120	(58)
	-----	-----
Net cash used for investing activities	(7,717)	(2,023)
	-----	-----
Cash flows from financing activities:		
Early extinguishment of senior notes	--	(63,934)
Proceeds from issuance of senior notes	--	60,000
Cash distributions / dividends to investors	(724)	(5,105)
Prepayment penalty	--	(4,278)
Borrowings (repayments) under the bank credit agreement, net	4,000	(4,000)
Repayments under other credit facilities, net	(332)	(311)
Purchase of treasury stock at cost	(6,499)	--
Principal payments under capitalized lease obligations	(60)	(36)
Other, net	--	(646)
	-----	-----
Net cash used for financing activities	(3,615)	(18,310)
	-----	-----
Net decrease in cash and cash equivalents	(4,528)	(3,411)
Cash and cash equivalents at beginning of period	14,702	6,085
	-----	-----
Cash and cash equivalents at end of period	\$ 10,174	\$ 2,674
	=====	=====

</TABLE>

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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SUNSOURCE INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)  
FOR THE NINE MONTHS ENDED,  
(dollars in thousands)

<TABLE>  
<CAPTION>

	September 30, 1998	September 30, 1997
	-----	-----
Cash flows from operating activities:		
<S>	<C>	<C>
Net income	\$ 10,786	\$ 26,050
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,186	4,382
Extraordinary loss	--	4,343
Decrease (increase) in cash value of life insurance	487	(653)
Transaction costs	--	3,053
Provision (benefit) for deferred compensation	(6)	2,184
Deferred income tax benefit	(1,508)	(10,866)
Changes in current operating items, net of		

businesses acquired:		
Increase in accounts and notes receivable	(17,303)	(12,062)
Decrease in inventories	2,118	2,643
Decrease in other current assets	948	436
Increase in accounts payable	2,934	6,592
Decrease in accrued interest	--	(460)
Increase in income taxes payable	338	139
Decrease in accrued restructuring charges and transaction costs	(962)	(3,402)
Increase in other accrued liabilities	4,953	1,261
Other items, net	(3,190)	(597)
	-----	-----
Net cash provided by operating activities	4,781	23,043
	-----	-----
Cash flows from investing activities:		
Proceeds from sale of property and equipment	379	695
Payments for acquired businesses, net of cash acquired	(17,644)	(704)
Capital expenditures	(3,703)	(3,252)
Investment in life insurance policies	(903)	(316)
Other, net	(269)	(24)
	-----	-----
Net cash used for investing activities	(22,140)	(3,601)
	-----	-----
Cash flows from financing activities:		
Net proceeds from issuance of common stock	20,813	--
Early extinguishment of senior notes	--	(63,934)
Proceeds from issuance of senior notes	--	60,000
Cash distributions / dividends to investors	(4,163)	(13,901)
Prepayment penalty	--	(4,278)
Borrowings under the bank credit agreement, net	13,000	6,000
Repayments under other credit facilities, net	(1,106)	(1,571)
Purchase of treasury stock at cost	(6,499)	--
Principal payments under capitalized lease obligations	(150)	(104)
Other, net	--	(646)
	-----	-----
Net cash provided by (used for) financing activities	21,895	(18,434)
	-----	-----
Net increase in cash and cash equivalents	4,536	1,008
Cash and cash equivalents at beginning of period	5,638	1,666
	-----	-----
Cash and cash equivalents at end of period	\$ 10,174	\$ 2,674
	=====	=====

</TABLE>

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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SUNSOURCE INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS'  
EQUITY FOR THE NINE MONTHS ENDED SEPTEMBER 30, 1998 (Unaudited)

(dollars in thousands)

<TABLE>  
<CAPTION>

Total	Accumulated					
	Additional			Other		
Stockholders' Equity / (Deficit)	Common Stock	Paid-in Capital	Retained Earnings	Unearned Compensation	Comprehensive Income (1)	Treasury Stock
-----	-----	-----	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>	<C>	
<C>						

Beginning Balance - December 31, 1997 \$ (491)	\$ 64	\$ -	\$ 1,735	\$ -	\$ (2,290)	
-----						
Net income 10,786			10,786			
Change in cumulative foreign translation adjustment (2,730)					(2,730)	
-----						
Comprehensive income 8,056						
-----						
Issuance of 796,408 shares of common stock in public offering 20,813	8	20,805				
Issuance of 924 shares of common stock to certain non-employee directors 22		22				
Dividends declared on common stock (2,128)			(2,128)			
Stock options granted at a discount 10		254		(244)		
Repurchase of 366,400 shares of common stock (6,499)					(6,499)	
-----	----	-----	-----	-----	-----	-----
Ending Balance - September 30, 1998 \$ 19,783	\$ 72	\$ 21,081	\$10,393	\$ (244)	\$ (5,020)	\$ (6,499)
=====	=====	=====	=====	=====	=====	=====

</TABLE>

(1) Cumulative foreign translation adjustment represents the only item of other comprehensive income.

SEE ACCOMPANYING NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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SUNSOURCE INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(dollars in thousands)

1. Basis of Presentation:

The accompanying financial statements include the consolidated accounts of SunSource Inc. (the "Company"), its predecessor, SunSource L.P. (the "Partnership"), and its wholly-owned subsidiaries including SDI Operating Partners, L.P. (the "Operating Partnership") and SunSource Capital Trust (the "Trust"). All significant intercompany balances and transactions have been eliminated. The Company is one of the leading providers of industrial and retail products and related value-added services in North America. The Company is



organized into three businesses which are SunSource Industrial Services Company, Hillman and Harding.

The accompanying consolidated financial statements and related notes are unaudited; however, in management's opinion all adjustments (consisting of normal recurring accruals) considered necessary for the fair presentation of financial position, income and cash flows for the periods shown have been reflected. Results for the interim period are not necessarily indicative of those to be expected for the full year.

Certain information in note disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles has been condensed or omitted pursuant to Form 10-Q requirements although the Company believes that disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the consolidated financial statements and notes thereto included in the Company's report on Form 10-K for the year ended December 31, 1997.

#### Treasury Stock

On August 6, 1998, the Company's Board of Directors authorized \$15,000 for management to repurchase up to 10% of the Company's outstanding common stock through open market transactions and private block trades, dependent upon market conditions. At September 30, 1998, the number of shares purchased under this authorization was 366,400 which are held in treasury. Through November 16, the Company had repurchased 408,200 shares at an aggregate cost of \$7,309.

#### Public Offering

On January 22, 1998, the Company filed a registration statement on Form S-2 with the United States Securities and Exchange Commission, which was amended thereafter, for an offering of Common Shares of the Company (the "Offering"). The registration statement became effective on March 19, 1998 and the Offering closed in its entirety on March 27, 1998. Of the 2,284,462 shares sold in the Offering, 796,399 shares were issued and sold by the Company and 1,488,063 shares were sold by the selling stockholders, affiliates of Lehman Brothers Inc. The Company received net cash proceeds of \$20,813 from the 796,408 shares sold in the Offering. The Company recorded an increase of \$8 in Common Stock and \$20,805 in Additional Paid-in Capital.

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### SUNSOURCE INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (dollars in thousands)

#### Common Shares Issued to Certain Non-Employee Directors

Under the Company's Stock Compensation Plan for Non-Employee directors, which was approved at the annual meeting of stockholders on April 28, 1998, and filed as an exhibit to the Form 10-Q, certain non-employee directors were issued 924 Common Shares through September 30, 1998. Prospectively, under the terms of the plan, non-employee directors will be issued Common Shares on a quarterly basis to cover 50% of their annual retainer fee with the amount of shares to be issued dependent upon the market price of the Common Shares and the number of directors receiving shares.

The number of outstanding Common Shares as of September 30, 1998 was 7,216,199. The weighted average number of Common Shares outstanding for the three and nine months ended September 30, 1998 was 7,120,576 and 6,939,106, respectively, including the shares sold in the offering and the shares issued to non-employee directors, net of the 366,400 shares repurchased and held in treasury.

#### Earnings Per Share

The Company accounts for earnings per share in accordance with Statement of Financial Accounting Standards No. 128 ("SFAS 128"), "Earnings per Share". SFAS 128 requires the presentation of basic and diluted earnings per share for companies with complex capital structures. Under the Company's Equity Compensation Plan, on July 30, 1998, certain executives and key employees were granted a total of 201,495 shares of the Company's common stock having a potentially dilutive effect on earnings per share. Currently, due to market conditions, the shares granted under the plan do not have a material dilutive effect on earnings per share for the three and nine months ended September 30,

1998. Therefore, in accordance with SFAS 128, the Company presents basic earnings per share only.

Due to the fact that the Company was not a corporation for the full year ended December 31, 1997, a pro forma net income per common share has been presented for the three and nine months ended September 30, 1997. Pro forma net income per common share assumes the Company's September 30, 1997 conversion to corporate form (the "Conversion") and refinancing of its debt occurred at the beginning of 1997 and accordingly excludes the extraordinary loss of \$0.53 per common share, as presented in the Company's 1997 annual report on Form 10-K. The 1997 pro forma earnings per share presented herein does not include the effect of the Offering which increased the number of common shares outstanding and provided cash which reduced the Company's bank revolving debt and interest expense.

## 2. Recent Accounting Pronouncements:

Effective with financial statements issued in 1998, the Company is required to implement Statement of Financial Accounting Standards ("SFAS") 130, "Reporting Comprehensive Income", which requires that changes in comprehensive income be shown in a financial statement that is displayed with the same prominence as other financial statements. Comprehensive income includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. Comprehensive income includes net income and other items resulting in changes to stockholders' equity such as foreign currency translation, minimum pension liability adjustments and unrealized gains and losses on certain investments in debt and equity securities.

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### SUNSOURCE INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (dollars in thousands)

The Company's only reportable item of comprehensive income is the change in the accumulated foreign translation adjustment. The Company now reports this item as a separate component of the Statement of Changes in Stockholders' Equity identified as the only additional component of Comprehensive Income.

The FASB issued SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits," in February 1998 with adoption required in 1998. This statement will result in additional disclosure related to the Company's defined benefit plans. It does not effect the accounting for these plans and will, therefore, not result in an impact to the balance sheet or income statement.

## 3. Acquisitions:

During the second quarter, the Company's Harding division acquired the assets of four retail glass shops for net cash consideration, including transaction expenses, of \$2,522 plus the assumption of certain liabilities of \$494. Harding recorded goodwill of \$2,165 related to these acquisitions.

During the third quarter, Harding acquired the assets of five retail glass shops for a net cash consideration of \$6,375 plus the assumption of certain liabilities of \$742. Harding recorded goodwill of \$5,970 related to these acquisitions.

On April 22, 1998, the Company's Hillman division acquired the assets of a manufacturer of letters, numbers and signs for net cash consideration of \$559, plus the assumption of certain liabilities of \$562. Hillman recorded goodwill of \$177 related to this acquisition.

On May 6, 1998, the Company's Hillman division acquired the assets of a distributor to retail hardware businesses for net cash consideration, including transaction expenses, of \$8,075 (of which \$1,738 is held in escrow pending the resolution of post-closing adjustments) plus the assumption of certain liabilities of \$193. Hillman recorded \$5,225 of goodwill related to this acquisition. The transaction was effective as of the close of business on May 2, 1998.

## 4. Common Stock Dividend:

On September 24, 1998, the Board of Directors declared a dividend of \$0.10 per Common Share which was paid on October 14, 1998 to holders of record as of October 6, 1998. The Company expects to declare future quarterly dividends on the Common Shares to aggregate \$0.40 per Common Share annually, subject to the discretion of its Board of Directors and dependent upon, among other things, the Company's future earnings, financial condition, capital requirements, funds needed for acquisitions, level of indebtedness, contractual restrictions and other factors that the Board of Directors deems relevant.

5. Lines of Credit and Long-Term Debt:

As of September 30, 1998, the Company had \$41,760 available under its \$90,000 Bank Credit Agreement which provides revolving credit for working capital purposes and acquisitions through September 30, 2002. The Company had \$106,902 of outstanding long-term debt and capital lease obligations at September 30, 1998, consisting of bank borrowings of \$46,000, outstanding senior notes of \$60,000 and capital lease obligations of \$902. The Company also had \$2,240 of Letters of Credit charged against its available borrowing on the revolving credit facility.

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SUNSOURCE INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(dollars in thousands)

5. Lines of Credit and Long-Term Debt, (continued):

The Company has another credit facility available in the amount of \$500 for letter of credit commitments only, of which no amount was outstanding as of September 30, 1998. In addition, an indirect, wholly-owned Canadian subsidiary of the Company has a \$2,500 Canadian dollar line of credit for working capital purposes of which no amount was outstanding at September 30, 1998.

6. Guaranteed Preferred Beneficial Interests in the Company's Junior Subordinated Debentures:

The Trust was organized in connection with the Conversion for the purpose of (a) issuing its Trust Preferred Securities to the Company in consideration of the deposit by the Company of Junior Subordinated Debentures in the Trust as trust assets, and its Trust Common Securities to the Company in exchange for cash and investing the proceeds thereof in an equivalent amount of Junior Subordinated Debentures and (b) engaging in such other activities as are necessary or incidental thereto. The Trust had no operating history prior to the issuance of the Trust Preferred Securities. The terms of the Junior Subordinated Debentures include those stated in the Indenture (the "Indenture") between the Company and the indenture trustee, and those made part of the Indenture by the Trust Indenture Act. The principal amount of the Junior Subordinated Debentures is \$108,707, consisting of \$3,261 related to the Trust Common Securities and \$105,446 related to the Trust Preferred Securities; the interest rate is 11.6%; and their maturity date is September 30, 2027, unless redeemed earlier.

The Company has guaranteed on a subordinated basis the payment of distributions on the Trust Preferred Securities and payments on liquidation of the Trust and redemption of Trust Preferred Securities (the "Preferred Securities Guarantee"). The sole assets of the Trust are the Junior Subordinated Debentures and the obligations of the Company under the Declaration of Trust of the Trust, the Indenture, the Preferred Securities Guarantee and the Junior Subordinated Debentures in the aggregate constitute a full and unconditional guarantee by the Company of the Trust's obligations under the Trust Preferred Securities. The distributions on the Trust Preferred Securities aggregate \$12,232 annually.

The Trust Preferred Securities will be redeemed upon maturity on September 30, 2027, or earlier redemption of the Junior Subordinated Debentures at 100% of the liquidation amount plus accrued and unpaid distributions, provided that any redemption due to a change in the tax status of the interest payments to the Trust within the first five years will be at 101%. The Trust Preferred Securities may be redeemed by the Company at any time after September 30, 2002, at the liquidation value of \$25 per security.

In the event of a liquidation of the Trust, the holders of Trust Preferred Securities would be entitled to receive a preferential distribution of \$25 per Trust Preferred Security, aggregating \$105,446, plus accrued and unpaid

distributions. However, upon the occurrence of an event which changes the tax status of interest payments to the Trust or the status of the Trust itself, the Trust will be liquidated and, after satisfaction of creditors of the Trust, the holders will receive Junior Subordinated Debentures.

The Trust Preferred Securities have equity characteristics but creditor's rights and are therefore classified between liabilities and stockholders' deficit on the balance sheet. On September 30, 1997, the Trust Preferred Securities were recorded at fair value of \$115,991 based on the price of the Class A interests of \$11.75 upon close of trading on the New York Stock Exchange on that date. The excess of the fair value of the Trust Preferred Securities on September 30, 1997 over their liquidation value of \$105,446, or \$10,545 is amortized over the thirty-year life of the Trust Preferred Securities.

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SUNSOURCE INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(dollars in thousands)

6. Guaranteed Preferred Beneficial Interests in the Company's  
Junior Subordinated Debentures, continued:

The interest payments on the Junior Subordinated Debentures underlying the Trust Preferred Securities, aggregating \$12,232 per year, are deductible for federal income tax purposes under current tax law and will remain an obligation of the Company until the Trust Preferred Securities are redeemed or upon their maturity in 2027.

7. Contingencies:

On February 27, 1996, a lawsuit was filed against the Company by the buyer of its Dorman Products division for alleged misrepresentation of certain facts by the Company upon which the buyer allegedly based its offer to purchase Dorman. The complaint seeks damages of approximately \$21,000.

Certain other legal proceedings are pending which are either in the ordinary course of business or incidental to the Company's business. Those legal proceedings incidental to the business of the Company are generally not covered by insurance or other indemnity.

The Company has recorded a provision of \$1.6 million in the third quarter of 1998 for resolution of outstanding matters related to divested businesses.

In the opinion of management, the ultimate resolution of these matters will not have a material effect on the consolidated financial position, operations or cashflows of the Company.

8. Subsequent Events:

On October 21, 1998, the Company's Hillman division acquired the assets of a manufacturer and distributor of letters, numbers, signs and related products for a net cash consideration of \$1,894 plus the assumption of certain liabilities.

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

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The following discussion provides information which management believes is relevant to an assessment and understanding of the Company's operations and financial condition. This discussion should be read in conjunction with the consolidated financial statements and notes thereto appearing elsewhere herein.

General

SunSource Inc. (the "Company") is one of the leading providers of industrial and retail products and related value-added services in North America. The Company is organized into three businesses which are SunSource Industrial Services Company, Hillman and Harding.

SunSource Industrial Services Company is comprised of Technology Services ("STS") and Inventory Management Services. STS offers a full range of technology-based products and services to small, medium and large manufacturers. Inventory Management Services are provided to low volume customers through Industrial Services expediter activity for small parts and to large industrial manufacturing customers through Industrial Services integrated supply activity.

Hillman operates in the Hardware Merchandising Services Segment, providing small hardware and related items and merchandising services, to retail outlets, primarily hardware stores, home centers and lumberyards.

Harding operates in the Glass Merchandising Segment, selling retail and wholesale automotive and flat glass and providing auto glass installation and small contract glazing services to individual consumers, insurance companies, autobody shops, and other customers through a large network of retail glass shops.

Stock Repurchase Plan

The Company, under the stock repurchase plan initiated August 6, 1998, had reacquired and placed into treasury 366,400 shares of common stock through September 30, 1998. The repurchase of the shares had a favorable antidilutive impact on earnings per share of \$.01 for the three months ended September 30, 1998, and an immaterial impact on earnings per share for the nine-month period then ended.

Public Offering

On January 22, 1998, the Company filed a registration statement on Form S-2 with the United States Securities and Exchange Commission, which was amended thereafter, for an offering of Common Shares of the Company (the "Offering"). The registration statement became effective on March 19, 1998 and the Offering closed in its entirety by March 27, 1998. Of the 2,284,471 shares sold in the Offering, 796,408 shares were issued and sold by the Company and 1,488,063 shares were sold by the selling stockholders, affiliates of Lehman Brothers, Inc.

The Company did not receive any of the proceeds from the shares sold by the selling stockholders. The Company used the net proceeds raised (of \$20.8 million) from the 796,408 shares sold in the Offering to repay borrowings under its revolving credit facility.

Acquisitions

The Company recently resumed its strategy to acquire retail glass shops for integration with Harding. From August 31, 1997, through December 31, 1997, Harding acquired the assets of three retail glass shops for net cash consideration of \$0.8 million, plus the assumption of certain liabilities. Sales from the acquired shops aggregated \$1.3 million for the nine months ended

September 30, 1998.

During the second quarter of 1998, Harding acquired the assets of four retail glass shops for net cash consideration, including transaction expenses, of approximately \$2.5 million plus the assumption of certain liabilities of \$0.5 million. Sales from these acquisitions were approximately \$4.5 million for the twelve-month period prior to acquisition. These acquisitions expand Harding's business into the Albuquerque, New Mexico, Dallas, Texas, and Phoenix, Arizona, markets.

During the third quarter of 1998, Harding acquired the assets of five retail glass shops for a net cash consideration of \$6.4 million plus the assumption of certain liabilities of \$0.7 million. Sales from these acquisitions were approximately \$9.3 million for the twelve-month period prior to acquisition. These acquisitions further expand Harding's business in the Arizona and Texas markets as well as expanding its business into New Hampshire and Georgia.

Sales from retail glass shops acquired during 1998 aggregated approximately \$13.8 million for the twelve-month period prior to acquisition by Harding.

On April 22, 1998, Hillman acquired the assets of a manufacturer of letters, numbers and signs for net cash consideration of approximately \$0.6 million plus the assumption of certain liabilities of \$0.6 million. This acquisition had sales of approximately \$1.0 million for the twelve-month period prior to acquisition.

On May 6, 1998, Hillman acquired the assets of the franchise and independent hardware segment of Axxess Technologies, Inc., including its PMI division, a distributor of keys, letters, numbers and signs and other products to retail hardware stores throughout the United States, for net cash consideration, including transaction expenses, of \$8.1 million (of which \$1.7 million is held in escrow pending the resolution of post-closing adjustments) plus the assumption of certain liabilities of \$0.2 million. Sales from the acquired operations were approximately \$17.0 million in 1997. Hillman will integrate the sales force and operations of the acquired business with its existing operations.

On October 21, 1998, Hillman acquired the assets of SIGN-KO, a Dallas-based manufacturer and distributor of letters, numbers, signs and related products for a net cash consideration of \$1.9 million. SIGN-KO serves a customer base that includes large home improvement retailers and independent hardware stores. Sales from the acquired operations were approximately \$3.0 million in 1997.

Sales from hardware-related companies acquired during 1998 aggregated approximately \$21.0 million for the twelve-month period prior to acquisition by Hillman.

Results of Operations  
Segment Sales and Profitability for the Three and Nine Months Ended  
September 30, 1998 and 1997  
<TABLE>  
<CAPTION>

ENDED, ----- September 30, 1997		(dollars in thousands)					
		FOR THE THREE MONTHS ENDED, ----- September 30, 1998		September 30, 1997		FOR THE NINE MONTHS ----- September 30, 1998	
% OF Sales AMOUNT	TOTAL	AMOUNT	% OF TOTAL	AMOUNT	% OF TOTAL	AMOUNT	% OF TOTAL
-----	-----	-----	-----	-----	-----	-----	-----
<S>	<C>	<C>	<C>	<C>	<C>	<C>	<C>
SunSource Industrial Services							
Technology Services		\$ 80,374	43.5%	79,167	44.3%	\$ 249,485	45.6%
241,724	45.7%						
Expediter		31,576	17.1%	31,922	17.9%	94,809	17.3%
95,934	18.1%						
Integrated Supply (1)		11,425	6.2%	14,828	8.3%	36,477	6.7%
41,823	7.9%						

-----	-----	-----	-----	-----	-----	-----	-----
379,481	Industrial Services 71.7%	123,375	66.7%	125,917	70.5%	380,771	69.6%
Hillman (2)		35,729	19.3%	29,015	16.3%	96,204	17.6%
83,072	15.7%						
Harding (3)		25,741	13.9%	23,608	13.2%	70,163	12.8%
66,646	12.6%						
-----	-----	-----	-----	-----	-----	-----	-----
529,199	Consolidated Net Sales 100.0%	\$ 184,845	100.0%	\$ 178,540	100.0%	\$ 547,138	100.0%
=====	=====	=====	=====	=====	=====	=====	=====

			% OF		% OF		% OF
			SALES		SALES		SALES
-----	-----	-----	-----	-----	-----	-----	-----
-----	-----	-----	-----	-----	-----	-----	-----
63,094	SunSource Industrial Services Technology Services 26.1%	\$ 21,591	26.9%	\$ 20,704	26.2%	\$ 64,750	26.0%
68,754	Expediter 71.7%	22,361	70.8%	22,807	71.4%	67,500	71.2%
10,604	Integrated Supply 25.4%	3,075	26.9%	3,733	25.2%	9,518	26.1%
-----	-----	-----	-----	-----	-----	-----	-----
142,452	Industrial Services 37.5%	47,027	38.1%	47,244	37.5%	141,768	37.2%
Hillman		19,506	54.6%	15,820	54.5%	52,092	54.1%
44,525	53.6%						
Harding		10,370	40.3%	9,727	41.2%	28,347	40.4%
27,222	40.8%						
-----	-----	-----	-----	-----	-----	-----	-----
214,199	Consolidated Gross Profit 40.5%	\$ 76,903	41.6%	\$ 72,791	40.8%	\$ 222,207	40.6%
=====	=====	=====	=====	=====	=====	=====	=====

-----	-----	-----	-----	-----	-----	-----	-----
10,873	SunSource Industrial Services Technology Services 4.5%	\$ 3,417	4.3%	\$ 3,353	4.2%	\$ 9,936	4.0%
15,712	Expediter 16.4%	5,412	17.1%	5,445	17.1%	15,875	16.7%
2,744	Integrated Supply 6.6%	418	3.7%	1,144	7.7%	1,554	4.3%
-----	-----	-----	-----	-----	-----	-----	-----
29,329	Industrial Services 7.7%	9,247	7.5%	9,942	7.9%	27,365	7.2%
Hillman		3,714	10.4%	3,516	12.1%	9,577	10.0%
8,209	9.9%						
Harding		1,815	7.1%	1,138	4.8%	3,363	4.8%
1,926	2.9%						
-----	-----	-----	-----	-----	-----	-----	-----
39,464	Total operations before corporate expenses 7.5%	14,776	8.0%	14,596	8.2%	40,305	7.4%
(6,462)	Corporate expenses (1.2%)	(2,315)	(1.3%)	(2,328)	(1.3%)	(6,187)	(1.1%)
-----	-----	-----	-----	-----	-----	-----	-----
33,002	Consolidated EBITA 6.2%	\$ 12,461	6.7%	\$ 12,268	6.9%	\$ 34,118	6.2%
=====	=====	=====	=====	=====	=====	=====	=====

</TABLE>

(1) Includes sales of \$1,607 and \$5,975 for the three and nine months ended September 30, 1998, respectively related to Integrated Supply contracts cancelled in 1998 and sales of \$4,669 and \$13,012 for the three and nine months ended September 30, 1997 respectively related to those contracts cancelled in 1997.

(2) Includes sales from acquired businesses of \$3,712 and \$5,956 for three and nine months ended September 30, 1998, respectively.

(3) Includes sales from acquired businesses of \$2,291 and \$2,922 for three and nine months ended September 30, 1998, respectively. Also includes sales from branches closed in 1998 of \$541 for the nine months ended September 30, 1998, and \$561 and \$1,592 for the three and nine months ended September 30, 1997, respectively.

(4) "EBITA" (earnings before interest, taxes, and amortization) is defined as income from operations before amortization, excluding \$840 and \$2,491 of management fees and \$2,428 and \$3,053 of transaction costs related to the Company's conversion from partnership to corporate form (the "Conversion"), for the three and nine month periods of 1997, respectively. EBITA is not a measure of financial performance under Generally Accepted Accounting Principals (GAAP).

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Three months ended September 30, 1998 and 1997

Net sales increased \$6.3 million or 3.5% in the three months ended September 30, 1998 to \$184.8 million from \$178.5 million in 1997. Sales variances by business segment are as follows:

	Sales Increase (Decrease)	
	Amount	%
	-----	-----
	(In thousands)	
SunSource Industrial Services Company		
Technology Services	\$ 1,207	1.5 %
Expediter	(346)	(1.1)%
Integrated Supply	(3,402)	(22.9)%
	-----	
Industrial Services	(2,541)	(2.0)%
Hillman	6,713	23.1 %
Harding	2,133	9.0 %
	-----	
Total Company	\$ 6,305	3.5 %
	=====	

STS sales increased \$1.2 million or 1.5% in the third quarter of 1998 to \$80.4 million from \$79.2 million due primarily to strong sales growth in mobile and automation technologies. The decrease in Expediter sales of \$0.3 million is due primarily to competitive pricing pressures as well as deterioration in the Canadian dollar. The decrease in Integrated Supply sales of \$3.4 million includes a net decrease of \$3.1 million due to contracts which were cancelled in 1998 and 1997.

Hillman's sales increased \$6.7 million or 23.1% in 1998 to \$35.7 million from \$29.0 million in 1997 due to market penetration of new product lines in the amount of \$1.1 million, sales from newly acquired businesses of \$4.1 million, and the balance of \$1.5 million in growth from new accounts and expansion of existing product lines.

Harding's sales increased \$2.1 million or 9.0% in 1998 to \$25.7 million from \$23.6 million in 1997 due primarily to an increase in retail sales of \$1.0 million or 6.8% and sales from businesses acquired since the fourth quarter of 1997 of \$2.7 million. In addition, the discontinuation of certain low margin product lines and markets served resulted in reduced sales of \$1.6 million. In recent years, Harding has discontinued certain low-margin product lines and has withdrawn from non- strategic markets. Growth in Harding's retail glass shops is expected to continue as a result of internal sales programs and the recent acquisitions.

The Company's sales backlog on a consolidated basis was \$65.3 million as of September 30, 1998, compared with \$68.3 million at December 31, 1997 and \$59.7 million at September 30, 1997, a decrease of 4.3% and an increase of 9.4%, respectively.

Total Company cost of sales increased \$2.2 million or 2.1% in 1998 to \$107.9 million from \$105.7 million in 1997 due primarily to increased sales levels in the comparison period.

The Company's consolidated gross margin was 41.6% in the third quarter of 1998 compared with 40.8% in the third quarter of 1997. SunSource Industrial Services Company's gross margin was 38.1% in 1998 compared with 37.5% in 1997, an increase of 0.6%. STS's gross margin increased 0.7% in 1998 due mainly to improved pricing. The Expediter activity's gross margin declined 0.6% in 1998 due mainly to competitive pricing pressures and higher freight costs.

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Integrated Supply gross margins increased 1.7% to 26.9% from 25.2% in the comparison period due primarily to sales mix. Hillman's gross margins remained consistent in the comparison period. Harding's gross margin decreased 0.9% due primarily to labor inefficiencies.

The Company's selling, general and administrative ("S,G&A") expenses increased by \$3.7 million or 6.2% to \$63.2 million in the third quarter of 1998 from \$59.5 million in 1997. Selling expenses increased \$2.1 million or 7.0% supporting increased 1998 sales levels Company-wide and increased marketing efforts at STS, Hillman and Harding. Warehouse and delivery expenses increased by \$0.9 million or 8.6%. The increase in general and administrative expenses of \$0.7 million or 3.4% is net of expense reductions of \$0.3 million associated with the replacement of cash basis deferred compensation awards with stock options.

S,G,&A expenses as a percentage of sales were as follows:

	Three Months Ended September 30, \	
	1998	1997
	----	----
Selling Expenses	17.3%	16.7%
Warehouse and Delivery Expenses	6.4%	6.1%
General and Administrative Expenses	10.5%	10.5%
	-----	-----
Total S,G&A Expenses	34.2%	33.3%
	=====	=====

EBITA was \$12.5 million for the three months ended September 30, 1998, excluding a \$1.6 million charge for litigation matters related to divested businesses, compared with \$12.3 million for the same prior-year quarter excluding a \$2.4 million charge for transaction and other costs associated with the Company's conversion from partnership to corporate form and non-recurring management fees of \$0.8 million.

The Company's consolidated operating profit margin ("EBITA, as a percentage of sales") after corporate expenses but excluding non-recurring charges decreased slightly to 6.7% in the third quarter of 1998 compared with 6.9% in the third quarter of 1997. SunSource Industrial Services Company's operating profit margin declined to 7.5% in 1998 from 7.9% in 1997, primarily reflecting slow third quarter 1998 sales growth as well as increased expenses relating to the restructuring effort at STS. Hillman's operating profit margin declined in 1998 to 10.4% from 12.1% in 1997 due to increased selling expenses as previously discussed and higher rebates paid to customers to attract new business. Harding's operating profit margin improved significantly in 1998 to 7.1% from 4.8% in 1997 due to improved sales resulting from investments in acquisitions and marketing efforts over the last twelve months, as well as reduced operating expenses.

The Company recorded a non-recurring charge of \$1.6 million for outstanding litigation matters related to divested businesses for the three months ended September 30, 1998.

Under partnership form, the management fee due the general partner amounted to \$3.3 million annually, of which \$0.8 million was expensed in the 1997 period. As a result of the Company's conversion from partnership to corporate form, the management fee is retained by a wholly-owned subsidiary of the Company and is eliminated in consolidation.

The Company pays interest to the Trust on the Junior Subordinated Debentures underlying the Trust Preferred Securities in the amount of 11.6% per annum on their face amount of \$105.4 million, or \$12.2 million. The Trust distributes an equivalent amount to the holders of the Trust Preferred Securities. For the three months ended September 30, 1998, the interest paid by the Company and the distributions made by the Trust amounted to \$3.1 million.

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Nine months ended September 30, 1998 and 1997

Net sales increased \$17.9 million or 3.4% in the first nine months of 1998 to \$547.1 million from \$529.2 million in 1997. Sales variances by business segment are as follows:

Sales Increase (Decrease)

	Amount (In thousands)	%
SunSource Industrial Services Company		
Technology Services	\$ 7,761	3.2 %
Expediter	(1,125)	(1.2) %
Integrated Supply	(5,345)	(12.8) %
	-----	
Industrial Services	1,291	0.3 %
Hillman	13,131	15.8 %
Harding	3,517	5.3 %
	-----	
Total Company	\$ 17,939	3.4 %
	=====	

STS sales increased \$7.8 million or 3.2% in the first nine months of 1998 to \$249.5 million from \$241.7 million in 1997 due mainly to strong sales growth in the mobile technology business. The decrease in Expediter sales of \$1.1 million is due primarily to competitive pricing pressures as well as deterioration in the Canadian dollar. The decrease in Integrated Supply sales of \$5.3 million includes a net decrease of \$7.0 million due to contracts which were cancelled in 1998 and 1997. Excluding these sales, Integrated Supply sales increased 5.9% in the first nine months of 1998 over the same prior-year period.

Hillman's sales increased \$13.1 million or 15.8% in 1998 to \$96.2 million from \$83.1 million in 1997 due to market penetration of new product lines in the amount of \$3.5 million, sales from newly acquired businesses of \$6.0 million, and the balance of \$3.6 million in growth from new accounts and expansion of existing product lines.

Harding's sales increased \$3.5 million or 5.3% in 1998 to \$70.2 million from \$66.7 million in 1997 due primarily to an increase in retail sales of \$2.9 million or 7.1%, and sales from businesses acquired since the fourth quarter of 1997 of \$4.2 million. In addition, the discontinuation of certain low margin product lines and markets served, as previously explained, resulted in reduced sales of \$3.6 million.

Total Company cost of sales increased \$9.9 million or 3.2% in 1998 to \$324.9 million from \$315.0 million in 1997 due primarily to increased sales levels in the comparison period.

The Company's consolidated gross margin was 40.6% in the first nine months of 1998 compared with 40.5% in the first nine months of 1997. SunSource Industrial Services Company's gross margin was 37.2% in 1998 compared with 37.5% in 1997, a decrease of 0.3%. STS's gross margin decreased 0.1% in 1998 due mainly to unabsorbed labor costs in its service and repair business. The Expediter activity's gross margin declined 0.5% in 1998 due mainly to competitive pricing pressures and higher freight costs. The Integrated Supply activity's gross margin increased 0.7% in 1998 due to the addition of product lines offset slightly by changes in sales mix as a result of new in-plant inventory management programs.

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Hillman's gross margin increased 0.5% due primarily to improved purchasing management and better control of obsolete and slow-moving inventories. Harding's gross margin decreased 0.4% due to an increase in contract sales at lower gross margins than the overall retail business.

The Company's S,G&A expenses increased by \$6.4 million or 3.6% to \$184.6 million in the first nine months of 1998 from \$178.2 million in 1997. Selling expenses increased \$4.0 million or 4.4% supporting increased 1998 sales levels Company-wide and increased marketing efforts at STS, Hillman and Harding. Warehouse and delivery expenses increased by \$1.1 million or 3.3%. The increase in general and administrative expenses of \$1.3 million or 2.4% in the comparison period is net of expense reductions of \$1.0 million associated with the replacement of cash basis deferred compensation awards with stock options.

S,G,&A expenses as a percentage of sales were as follows:

Nine Months Ended	
September 30,	
1998	1997
----	----

Selling Expenses	17.2%	17.0%
Warehouse and Delivery Expenses	6.0%	6.0%
General and Administrative Expenses	10.5%	10.6%
	-----	-----
Total S,G&A Expenses	33.7%	33.6%
	=====	=====

EBITA was \$34.1 million for the nine months ended September 30, 1998, compared with \$33.0 million for the same prior-year period excluding the previously mentioned non-recurring charges in 1998 and 1997.

The Company's consolidated operating profit margin after corporate expenses but excluding non-recurring charges was constant at 6.2% in the first nine months of 1998 compared with the first nine months of 1997. SunSource Industrial Services Company's operating profit margin declined to 7.2% in 1998 from 7.7% in 1997, primarily reflecting slow 1998 sales growth and increased expenses related to the restructuring effort. Hillman improved its operating profit margin slightly in 1998 to 10.0% from 9.9% in 1997 due to increased sales and gross profit margin improvement from better purchasing management in the first quarter of 1998 as previously discussed. Harding's operating profit margin improved in 1998 to 4.8% from 2.9% in 1997 due to improved sales resulting from significant investments in sales and marketing efforts and acquisitions over the last twelve months and reduced operating expenses, offset by a decline in gross profit margin due to sales mix as previously discussed.

Under partnership form, the management fee due the general partner amounted to \$3.3 million annually, of which \$2.5 million was expensed in the 1997 period. As a result of the Company's corporate conversion, the management fee is retained by a wholly-owned subsidiary of the Company and is eliminated in consolidation.

The Company pays interest to the Trust on the Junior Subordinated Debentures underlying the Trust Preferred Securities in the amount of 11.6% per annum on their face amount of \$105.4 million, or \$12.2 million. The Trust distributes an equivalent amount to the holders of the Trust Preferred Securities. For the nine months ended September 30, 1998, the interest paid by the Company and the distributions made by the Trust amounted to \$9.2 million.

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The Company is subject to federal, state and local income taxes on its domestic operations and foreign income taxes on its Canadian and Mexican operations as accounted for in accordance with Statement of Financial Accounting Standard ("SFAS") 109, "Accounting for Income Taxes". The Company's combined effective tax rate was 36.2% for the nine months ended September 30, 1998. The effective tax rate includes the effect of a favorable non-recurring prior-year income tax adjustment of \$1.1 million to estimated 1997 income taxes recorded in the three and nine month periods ended September 30, 1998. Excluding this adjustment, the effective tax rate is 42% in 1998. The Company expects this rate to remain constant due to the implementation of recently identified state and local tax planning strategies. Deferred income taxes represent differences between the financial statement and tax bases of assets and liabilities as classified on the Company's balance sheet.

#### Liquidity and Capital Resources

Earnings before interest, taxes, depreciation and amortization ("EBITDA") increased \$2.2 million or 21.9% to \$12.1 million in the third quarter of 1998 from \$9.9 million in the same prior-year quarter and increased \$6.0 million or 19.7% to \$36.4 million in the first nine months of 1998 from \$30.4 million in the first nine months of 1997. The Company's net interest coverage ratio on a pro forma basis for the nine months ended September 30, 1998 improved to 2.34x (earnings before interest, distributions on Trust Preferred Securities and income taxes over net interest expense and distributions on Trust Preferred Securities), from 2.23x in the comparable 1997 period.

The Company's cash position of \$10.2 million as of September 30, 1998, increased \$4.5 million from the balance at December 31, 1997. Cash was provided during this period primarily from operations (\$4.8 million), net borrowings on the bank revolver (\$13.0 million), proceeds from the sale of property and equipment (\$0.4 million), and net proceeds from the Offering (\$20.8 million). Cash was used during this period predominantly for acquisitions (\$17.6 million), cash distributions to investors (\$4.2 million), capital expenditures (\$3.7 million), purchase of treasury stock (\$6.5 million), net repayments on other credit facilities (\$1.1 million), investment in life insurance (\$0.9 million) and other

items, net (\$0.5 million).

The Company's working capital position of \$137.9 million at September 30, 1998, represents an increase of \$17.0 million from the December 31, 1997 level of \$120.9 million, primarily due to the proceeds from the Offering. The Company's current ratio improved to 2.52x at September 30, 1998 from 2.41x at December 31, 1997, principally due to an increase in cash and accounts receivable.

As of September 30, 1998, the Company had \$41.8 million available under its credit facilities. The Company had \$106.9 million of outstanding long-term debt at September 30, 1998, consisting of the \$60.0 million Senior Note at 7.66%, bank borrowings totaling \$46.0 million at an effective interest rate of 6.62%, and capitalized lease obligations of \$0.9 million at various interest rates. On October 5, 1998, the Company utilized its excess cash to repay a \$6.0 million one-month LIBOR loan on its bank revolver. An indirect, wholly-owned Canadian subsidiary of the Company had a \$2.5 million Canadian dollar line of credit for working capital purposes, of which no amount was outstanding at September 30, 1998.

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As of September 30, 1998, the Company's total debt (including dividends/distributions payable) as a percentage of its consolidated capitalization (total debt, Trust Preferred Securities and stockholders' equity) was 44.3% compared with 45.6% as of December 31, 1997 and 45.8% as of September 30, 1997. The Company's consolidated capitalization (including dividends/distributions payable) as of September 30, 1998, was \$243.1 million compared to \$212.1 million at December 31, 1997 and \$208.2 million at September 30, 1997.

The Company anticipates spending \$4.5 million for capital expenditures in 1998, primarily for warehouse improvements, machinery and equipment and computer hardware and software.

The Company paid \$2.1 million on February 27, 1998, for remaining tax distributions due to Class B interest holders of the predecessor partnership, related to taxable income for the nine months ended September 30, 1997.

On June 24, 1998, the Board of Directors declared a dividend of \$0.10 per Common Share which was paid on July 14, 1998, to holders of record as of July 6, 1998. On September 24, 1998, the Board of Directors declared a dividend of \$0.10 per Common Share which was paid on October 14, 1998 to holders of record as of October 6, 1998. The Company expects to declare future quarterly dividends on the Common Shares to aggregate \$0.40 per Common Share annually, subject to the discretion of its Board of Directors and dependent upon, among other things, the Company's future earnings, financial condition, capital requirements, funds needed for acquisitions, level of indebtedness, contractual restrictions and other factors that the Board of Directors deems relevant.

The Company has deferred tax assets aggregating \$15.7 million as of September 30, 1998, as determined in accordance with SFAS 109. Management believes that the Company's deferred tax assets will be realized through the reversal of existing temporary differences between the financial statement and tax bases, as well as through future taxable income.

Year 2000 Issue

The Company believes that both its proprietary and purchased computer software systems are an integral part of its business and growth strategies. The Company depends on these computer-based information technology ("IT") systems generally to process orders, to manage inventory and accounts receivable collections, to purchase, sell and ship products efficiently and on a timely basis, to maintain cost-effective operations and to provide superior service to its customers.

Each of the Company's five segments have distinct IT systems and therefore each has its own plan for addressing the Year 2000 issue (Y2K). One individual in the Company's Industrial Services business is responsible for the Y2K plans in the STS, Expediter and Integrated Supply segments. Hillman and Harding each have one individual responsible for the Y2K plans in their businesses. These three individuals are required to provide senior management of the Company with a detailed quarterly update on the status of their Y2K plans. The individual responsible for the Y2K plan at SunSource Industrial Services recently resigned. The Company expects to name a replacement shortly and does not anticipate any significant delay in implementing its Y2K plan.

The following discussion relates primarily to the Company's IT systems. The Company recognizes that other machinery and equipment may possibly have Y2K exposure due to the use of micro-controllers ("non-IT" systems). In general, however, the Company's exposure to non-IT systems is limited because most of its operations do not require machinery and equipment with imbedded micro-controllers.

SunSource Industrial Services

- o The Expediter Segment has evaluated all its IT systems and has identified those requiring remediation. The mainframe and financial computer hardware and related operating systems have been determined to be Y2K compliant. Expediter's critical proprietary application software programs require full remediation. This process has been out-sourced to an independent consultant, is approximately 30% complete and is targeted for completion and testing by the end of the third quarter of 1999. Expediter's assessment of critical hardware and software purchased from third party vendors resulted in a determination that certain file server and personal computer ("PC") hardware and software applications such as inventory planning and purchasing, and its financial software, were not Y2K compliant. Expediter recently began to upgrade or replace these systems and expects to complete this process with full testing by the fourth quarter of 1999.
- o STS is in the process of converting all of its operating units to a third-party purchased computer system as part of the restructuring of this segment. The new computer hardware, operating system and application software have all been certified by the vendor as being Y2K compliant. The conversion project is approximately 50% complete and is targeted for full completion and testing by mid-1999. STS has also identified other purchased software programs used in conjunction with the primary system which must be upgraded to Y2K compliant versions. These upgrades are expected to be installed during the second quarter of 1999.
- o A The critical third-party IT system for Integrated Supply's domestic operations has a Y2K compliant version that has been released and is expected to be installed by the end of 1998. Certain other software applications used in conjunction with this system require upgrades which are also targeted for installation by the end of 1998.
- o A Most of the Company's international activities are conducted using IT systems covered by the foregoing discussion. The separate operating systems at Integrated Supply's Mexican operations are expected to be upgraded to Y2K compliant versions by mid-1999. The Company's net sales from foreign operations is less than 7% of its consolidated net sales.

Hillman

Hillman has completed remediation (including full testing) on approximately 90% of its proprietary software programs. The remaining 10% of these programs include certain high priority programs (i.e., date sensitive) that are expected to be completed by the end of 1998, and other lower priority programs which are expected to be completed by mid-1999. Hillman's critical purchased software applications and hardware are currently compliant (verified by letters from the vendors) except for several applications (i.e. payroll, telephone and shipping) which are expected to be upgraded or replaced in early 1999.

Harding

Harding's critical purchased point-of-sale software application is Y2K compliant and its related hardware operating system has a Y2K compliant release which Harding has recently started installing at each of its over 100 locations; this process is expected to be completed by the end of the third quarter of 1999. Harding's purchased financial software requires a version update to become Y2K compliant which is expected to be installed in early 1999. An assessment of Harding's network servers and PC hardware to determine Y2K compliance is targeted for completion by the end of 1998, with any necessary remediation scheduled to be completed by mid-1999. An assessment of Y2K compliance for each site's telephone system is expected by the end of 1998 with corrective action for any non-compliant systems scheduled for completion by mid-1999.

Acquisitions

All of the Company's recent acquisitions have been evaluated for Y2K compliant systems and two have been identified as not having Y2K compliant systems. These two systems are in the process of being evaluated and the Company anticipates that these systems will be successfully converted to Y2K compliant versions before the fourth quarter of 1999. Prospectively, the Company will require certification of Y2K compliance as part of its purchase agreements.

#### Costs to Address Year 2000 Issues

The Company's Y2K costs incurred through September 1998 are approximately \$.3 million. The Company projects Y2K costs for the fourth quarter of 1998 to be approximately \$.4 million for total projected 1998 costs of \$.7 million. Approximately 80% of these costs are related to remediation of internally designed software applications. Y2K costs of \$1.0 million are expected to be incurred during 1999, with approximately 20% for remediation of internally designed software applications, resulting in projected aggregate costs of \$1.7 million for the entire Y2K project. The source of the funds for these Y2K costs will be from the Company's operating cash flows.

#### Risks of Year 2000 Compliance

The Company believes that its most significant risk associated with the Y2K problem is that certain vendors may not be able to supply products to the Company's operating businesses. The Company believes that this situation would only result in a temporary interruption in service for the following reasons:

- o A The Company does not have any single supplier that provides more than 8% of its total annual purchases.
- o A The Company's purchasing functions and distribution centers are geographically diversified which allows greater access to various suppliers.

As a preemptive measure, the Company's businesses have requested Y2K compliance letters from their major suppliers and have issued second requests where necessary. The Company has received responses from approximately 40% of its suppliers. At this time, no significant Y2K issues have been communicated from major suppliers that have responded. The Company recognizes, however, that certain suppliers may not respond to these requests and therefore the Company may not be able to fully evaluate the extent of its risk in this area. To limit the risk of supply shortages in early 2000, however, the Company's businesses plan to increase inventory levels for selected product lines as a measure to ensure proper fill rates.

The Company also recognizes the risk that unresolved Y2K issues within its customer base could result in the Company not being able to sell its products to such Customers. This Company believes that such risk is significantly limited since no individual customer accounts for more than 5% of the Company's revenue.

In addition to the plans described above, each of the Company's businesses expects to obtain commitments from outside computer consultants to be available in late 1999 and early 2000 should any critical IT problems develop during that period. The Year 2000 disclosures contained in this report involve risks and uncertainties and may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements reflect management's current views and are based upon certain assumptions. Actual results could differ materially from those currently anticipated as a result of a number of factors, including the risks and uncertainties discussed under the captions "Risk Factors" set forth in Item 1 of the Company's Annual Report on Form 10-K for the year ended December 31, 1997, as filed with the Securities and Exchange Commission. Given these uncertainties, current or prospective investors are cautioned not to place undue reliance on any such forward-looking statements. Furthermore, the Company disclaims any obligation or intent to update any such forward-looking statement to reflect future events or developments.

Items 1 - 6 - None  
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SIGNATURES

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

SUNSOURCE INC.

-----  
Joseph M. Corvino  
Vice President - Finance  
(Chief Financial Officer)

-----  
John J. Dabrowski  
Controller  
(Chief Accounting Officer)

DATE: November 16, 1998



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This schedule contains summary financial information extracted from the Balance Sheet as of September 30, 1998 and the related statement of income for the year-to-date ended September 30, 1998.

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<FN>

<F1> Bonds represents all long-term debt for senior notes.

<F2> Represents guaranteed preferred beneficial interests in the corporations junior subordinated debentures.

</FN>

</TABLE>