

TORO CO
Form 10-K
December 22, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For Fiscal Year Ended October 31, 2006.**

THE TORO COMPANY

(Exact name of registrant as specified in its charter)

Delaware
(State of incorporation)

1-8649
(Commission File Number)

41-0580470
(I.R.S. Employer Identification
Number)

**8111 Lyndale Avenue South
Bloomington, Minnesota 55420-1196
Telephone number: (952) 888-8801**

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value \$1.00 per share	New York Stock Exchange
Preferred Share Purchase Rights	New York Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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.

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Large accelerated filer Accelerated filer Non-accelerated filer

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, based on the closing price of the Common Stock on May 5, 2006, the last business day of the registrant's most recently completed second fiscal quarter, as reported by the New York Stock Exchange, was approximately \$2.1 billion.

The number of shares of Common Stock outstanding as of December 15, 2006 was 41,044,271.

Documents Incorporated by Reference

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Portions of the registrant's Proxy Statement for the Annual Meeting of Stockholders to be held March 13, 2007 are incorporated by reference into Part III.

**THE TORO COMPANY
FORM 10-K
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PART I

ITEM 1. BUSINESS

Introduction

The Toro Company was incorporated in Minnesota in 1935 as a successor to a business founded in 1914 and reincorporated in Delaware in 1983. Unless the context indicates otherwise, the terms company, Toro, we, and our refer to The Toro Company and its subsidiaries. Our executive offices are located at 8111 Lyndale Avenue South, Bloomington, Minnesota 55420-1196, telephone number (952) 888-8801. Our Internet address for Toro branded product related information is www.toro.com and our web site for corporate and investor information is www.thetorocompany.com. The information contained on our web sites or connected to our web sites is not incorporated by reference into this Annual Report on Form 10-K and should not be considered part of this report.

We design, manufacture, and market professional turf maintenance equipment and services, turf and micro irrigation systems, landscaping equipment, and residential yard products. We produced our first mower for golf course use in 1921 and our first lawn mower for home use in 1939, and we have continued to enhance our product lines ever since. We classify our operations into two reportable segments: professional and residential. A third segment called other consists of domestic company-owned distributorships, corporate functions, and Toro Credit Company, a wholly owned financing subsidiary. Net sales of our segments accounted for the following approximate percentages of our consolidated net sales for fiscal 2006: Professional, 67 percent; Residential, 31 percent; and Other, 2 percent.

Our products are advertised and sold at the retail level under the primary trademarks of Toro®, Toro® Wheel Horse®, Lawn-Boy®, Irritrol®, Exmark®, Toro® Dingo®, Aqua-TraXX®, Pope®, Hayter®, and Lawn Genie®, most of which are registered in the United States and/or in the principal foreign countries where we market our products. This report also contains trademarks, trade names, and service marks that are owned by other persons or entities, such as The Home Depot.

We emphasize quality and innovation in our customer service, products, manufacturing, and marketing. We strive to provide well-built, dependable products supported by an extensive service network. We have committed funding for engineering and research in order to improve existing products and develop new products. Through these efforts, we seek to be responsive to trends that may affect our target markets now and in the future. A sizeable portion of our revenue has historically been attributable to new and enhanced products. Our mission is to be the leading worldwide provider of outdoor landscaping products, support services, and integrated systems that help customers preserve and beautify their outdoor landscapes with environmentally responsible solutions of customer-valued quality and innovation. Additional information on our strategic initiatives is included in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of this report.

Products by Market

We strive to be a leader in adapting advanced technologies to products and services that provide solutions for landscape, turf care maintenance, and residential demands. The following is a summary of our products by market for the professional and residential segments:

Professional We design professional turf products and market them worldwide through a network of distributors and dealers as well as directly to government customers and rental companies. Products are sold by distributors and dealers to professional users engaged in maintaining and creating landscapes, such as golf courses, sports fields, municipal properties, and residential and commercial landscapes. Professional turf maintenance equipment marketed under the Toro brand name is our oldest product line that began in 1921 with tractor-towed mowers for golf courses. Over time, we have expanded our product lines to include products designed for large turf areas, such as golf courses, schools, parks, cemeteries, sports fields, industrial sites, apartments, and townhouse complexes.

Landscape Contractor Market. Products for the landscape contractor market include zero-turn radius riding mowers, 21-inch heavy-duty walk behind mowers, mid-size walk behind mowers, and compact utility loaders. These products are sold through distributors and dealers, and are also available through rental centers to individuals and companies who maintain and create residential and commercial landscapes on behalf of property owners. We market products to landscape contractors under the Toro, Exmark, and Lawn-Boy brands.

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In fiscal 2006, we introduced a new line of fixed and floating deck mid-sized walk-behind commercial mowers, featuring the same high performance Turboforce® deck technology used on the Toro zero-turn radius riding mowers. In fiscal 2006, we also introduced the Exmark Phazer , a compact commercial zero-turn radius riding mower for landscape professionals with smaller properties unsuitable for larger commercial riders, and the Exmark FrontRunner , a front mount commercial zero-turn radius riding mower with a hydraulic deck lift and fold for enhanced serviceability.

Our compact utility loaders are cornerstone products for the Toro Sitework Systems product line. These products are designed to improve efficiency in the creation of landscapes. We offer over

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35 attachments for our compact utility loaders, including trenchers, augers, vibratory plows, and backhoes. In fiscal 2006, we introduced two new diesel-powered compact utility loaders.

Sports Fields and Grounds Market. Products for the sports fields and grounds market include riding rotary units with cutting widths ranging from 21 inches to 16 feet, aerators, attachments, and debris management products, which include versatile debris vacuums, blowers, and sweepers. Other products include multipurpose vehicles, such as the Workman®, that can be used for turf maintenance, towing, and industrial hauling. These products are sold through distributors, who then sell to owners and/or managers of sports fields, municipal and institutional properties, cemeteries, and facilities such as airports and corporate headquarters. In fiscal 2006, we introduced the Infield Pro® 3040 and 5040 infield groomers, featuring the new Quick Attachment System that provides attachment changes without the use of tools for most of the 17 attachments.

Residential/Commercial Irrigation Market. Turf irrigation products marketed under the Toro and Irritrol brand names include sprinkler heads, brass and plastic valves, and electric and hydraulic control devices designed to be used in residential and commercial turf irrigation systems. These products are professionally installed in new systems and can also be used to replace or retrofit existing systems. Most of the product line is designed for underground irrigation systems. Electric and hydraulic controllers activate valves and sprinkler heads in a typical irrigation system. We also offer wireless rain and freeze switches on some products in an effort to conserve water usage. Our IntelliSense® and SmartDial® controllers self-adjust their watering schedules based on current environment conditions. In fiscal 2006, we introduced the Irritrol® PC Control® residential controller system, featuring wireless transmission of watering and landscape lighting schedules between a user's personal computer and the irrigation controller.

Golf Course Market. Products for the golf course market include large reel and rotary riding products for fairway, rough and trim cutting; riding and walking mowers for putting greens and specialty areas; turf sprayer equipment; utility vehicles; turf aerators, including the ProCore® 648 walk-behind aerator; and bunker maintenance equipment. We also manufacture and market underground irrigation systems, including sprinkler heads and controllers that activate electric, battery-operated, or hydraulic valves. Our professional irrigation systems are designed to use computerized management systems and a variety of technologies to help customers manage their consumption of water. Our 835S/855S Series golf sprinklers are equipped with a unique TruJectory® feature that provides enhanced water distribution control as well as uniformity, nozzle flexibility, and system efficiency. Our Network VP® Satellite also provides an upgrade path to customers with existing controllers.

In fiscal 2006, we introduced four models to the all-new Reelmaster® 5010 Series of fairway mowers, featuring Dual Precision Adjustment cutting units, improved serviceability and comfort features, and an optional upgrade that enhances traction and climbing ability with the CrossTrax® all-wheel drive system. In fiscal 2006, we also introduced the Sand Pro® 3040 and 5040 professional golf course bunker management machines that feature the new Quick Attachment System that provides attachment changes without the use of tools for most of the Sand Pro's 17 attachments. In fiscal 2006, we also introduced the Groundsmaster® 3280-D compact rotary mowers to our international markets.

Micro-Irrigation Market. Products for the micro-irrigation market include emission devices that regulate flow for drip irrigation, including Aqua-TraXX® drip tape, patented Aqua-TraXX® PC (pressure-compensating), Blue Stripe® polyethylene tubing, and Drip In® drip line, all used in agriculture, mining, and landscape applications. These products are sold primarily through dealers and distributors who then sell to end users for use primarily in vegetable fields, fruit and nut orchards, vineyards, and landscapes. In fiscal 2006, we introduced a product life-cycle management program that includes an industry-first recycling service and permanent identification for ease of installation.

Residential We market our residential products to homeowners through a variety of distribution channels, including dealers, hardware retailers, home centers, mass retailers, and over the Internet. These products are sold mainly in North America, Europe, and Australia, with the exception of snow removal products, which are sold primarily in North America and Europe. We also license our trade name to other manufacturers and retailers on certain products as a means of expanding our brand name presence.

Walk Power Mower Products. We manufacture and market numerous walk power mower models under our Toro and Lawn-Boy brand names, as well as the Pope brand name in Australia and the Hayter brand name in the United Kingdom. Models differ as to cutting width, type of starter mechanism, ability to mulch, bag or side discharge grass clippings, cast aluminum or steel decks, controls, and power sources, and are either self-propelled or push mowers. Toro brand lawn mowers are backed by our *Guaranteed To Start* program. We also offer a line of rear roller walk power mowers, a design that provides a striped finish for the United Kingdom market. In fiscal 2006, we introduced two models of the Eurocyclor , an electric mower designed exclusively for the European homeowner.

Riding Products. We manufacture and market riding products under the Toro and Lawn-Boy brand names and the Hayter brand name in the United Kingdom. Riding mowers and tractors include a rear engine riding mower manufactured and sold in the European market; lawn tractor models; and garden tractor models. Many models are available with a variety of decks and accessories.

Recycler cutting decks are available on some models. Models can be equipped with manual, automatic, or hydrostatic transmissions. In recent years, we introduced a new line of riding products, the TimeCutter® zero-turning radius riding mowers. In early fiscal 2007, we introduced four new models to the TimeCutter® line of zero-turning radius riding mowers, featuring larger engines and deck options and other enhancements designed to further reduce mowing time for homeowners. We also manufacture riding mower products plus attachments for a third party under a private label agreement. In fiscal 2006, we introduced the LX Series and GT2000 Series value-priced lawn and garden tractors to the North American market. In fiscal 2006, we also introduced a new D-Series lawn tractor to the European market, featuring a larger engine and improved comfort features.

Home Solutions Products. We design and market home solutions products under the Toro and Pope brand names, including electric and battery operated flexible line grass trimmers, electric blowers, electric blower-vacuums, and electric snow throwers. The versatile electric Power Shovel Plus is an innovative machine for every season that can clear snow up to six inches deep and sweep away dirt, leaves, and other debris from hard surfaces. In fiscal 2007, we introduced three new electric blower-vacuum models, featuring a more powerful air force and an improved flow rate.

Retail Irrigation Products. We design and market underground retail irrigation products under the Toro and Lawn Genie brand names. In Australia, we also design and market underground and hose-end retail irrigation products under the Pope brand name. These products are designed for homeowner installation and include sprinkler heads, valves, and electronic and mechanical timers. Our ECXTRA® sprinkler timers can be used with a home computer and our Scheduling Advisor® recommends the proper watering schedule based on the local weather, plant type, and sprinkler. We also design and market drip irrigation systems for residential landscapes and gardens.

Gas Snow Removal Products. We manufacture and market a range of gas-powered single-stage and two-stage snow thrower models under the Toro and Lawn-Boy brand names. Single-stage snow throwers are walk behind units with lightweight two-cycle gasoline engines. Most single-stage snow thrower models include Power Curve® snow thrower technology. Our large two-stage snow throwers are designed for relatively large areas of deep, heavy snow falls and use two- and four-cycle engines, and include a line of innovative models featuring the Power Max® auger system for enhanced performance and the Quick Stick® chute control technology. We also manufacture and market hybrid models with single-stage snow thrower technology that are self-propelling, providing the operational ease of a single-stage snow thrower with the power of a two-stage unit. In fiscal 2006, we introduced a new line of compact two-stage snow throwers.

Financial Information About Foreign Operations and Business Segments

We manufacture our products in the United States, Mexico, Australia, Italy, and the United Kingdom for sale throughout the world and maintain sales offices in the United States, Belgium, the United Kingdom, France, Australia, Singapore, Japan, China, Italy, and Switzerland. New product development is pursued primarily in the United States. Our net sales outside the United States were 27.0 percent, 24.8 percent, and 20.7 percent of total consolidated net sales for fiscal 2006, 2005, and 2004, respectively.

A portion of our cash flow is derived from sales and purchases denominated in foreign currencies. To reduce the uncertainty of foreign currency exchange rate movements on these sales and purchase commitments, we enter into foreign currency exchange contracts for select transactions. For additional information regarding our foreign currency exchange contracts, see Item 7A entitled

Quantitative and Qualitative Disclosures about Market Risk. For additional financial information regarding our foreign operations and each of our segments, see Note 11 of Notes to Consolidated Financial Statements entitled Segment Data, included in Item 8 of Part II of this report.

Manufacturing and Production

In some areas of our business, we are primarily an assembler, while in others we serve as a fully integrated manufacturer. We have strategically identified specific core manufacturing competencies for vertical integration and have chosen outside vendors to provide other services. We design component parts in cooperation with our vendors, contract with them for the development of

tooling, and then enter into agreements with these vendors to purchase component parts manufactured using the tooling. In addition, our vendors regularly test new technologies to be applied to the design and production of component parts. Manufacturing operations include robotic and computer-automated equipment to speed production, reduce costs, and improve the quality, fit, and finish of products. Operations are also designed to be flexible enough to accommodate product design changes required to respond to market demand.

In order to utilize our manufacturing facilities and technology more effectively, we pursue continuous improvements in our manufacturing processes with the use of Lean methods, which are intended to streamline work and eliminate waste. We have some flexible assembly lines that can handle a wide product mix and deliver products when customers require them. Additionally, we spend considerable effort to reduce manufacturing costs through Lean methods and process improvement, product and platform design, application of advanced technology, enhanced environmental management systems, SKU consolidation, safety improvements, and better supply-chain management. We also manufacture products sold under a private label agreement to a third party on a competitive basis, and we have agreements with

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other third party manufacturers to manufacture products on our behalf.

Our professional products are manufactured throughout the year. Our residential spring and summer products are also generally manufactured throughout the year. However, our residential fall and winter products are generally manufactured in the summer and fall months. Our products are tested in conditions and locations similar to those in which they are used. We use computer-aided design and manufacturing systems to shorten the time between initial concept and final production.

Our production levels and inventory management goals are based on estimates of demand for our products, taking into account production capacity, timing of shipments, and field inventory levels. We also periodically shut down production to allow for maintenance, rearrangement, and capital equipment installation at our manufacturing facilities. Capital expenditures for fiscal 2007 are expected to be approximately \$45 to \$50 million, which is \$5 to \$10 million higher than fiscal 2006 capital expenditures as we expect to continue to invest in manufacturing equipment and tooling for new products.

Engineering and Research

We are committed to an ongoing engineering program dedicated to developing innovative new products and improvements in the quality and performance of existing products. However, a focus on innovation also carries certain risks that new technology will be slow to be or not accepted by the marketplace. We attempt to mitigate this risk through our focus on and commitment to understanding our customers' needs and requirements. We are investing more time upfront with customers, using Voice of the Customer tools to ensure we develop innovative products that will be valued by our customers. We are also utilizing Design for Manufacturing and Assembly (DFMA) tools and enhancing our New Product Development System to ensure early manufacturing involvement in new product designs to reduce product cost. DFMA focuses on reducing the number of parts required to assemble new products as well as designing products to move more efficiently through the manufacturing process. We are also making several improvements to our engineering process as part of our Lean initiatives.

Our engineering expenses are primarily incurred in connection with the development of new products that may have additional applications or represent extensions of existing product lines, improvements to existing products, and cost reduction efforts. Our expenditures for engineering and research were approximately \$57.3 million (3.1 percent of net sales) in fiscal 2006, \$52.6 million (3.0 percent of net sales) in fiscal 2005, and \$48.0 million (2.9 percent of net sales) in fiscal 2004. In fiscal 2007, we anticipate engineering and research costs to increase compared to fiscal 2006 as we plan to continue to invest in new product development.

Raw Materials

Most of the components of our products are commercially available from a number of sources and are in adequate supply. Therefore, we are generally not dependent on any one supplier, except for engines from Japanese suppliers used in some of our professional segment products.

In fiscal 2006, we experienced no significant work stoppages as a result of shortages of raw materials or commodities. The highest value component costs are generally engines, steel, transmissions, transaxles, hydraulics, electric motors, and plastic resin purchased from several suppliers around the world. We have some long-term commitments for the purchase of various component parts and raw materials that management believes are unlikely to be terminated prematurely.

During fiscal 2006, we continued to experience an increase in commodity costs, which resulted in a negative impact on our gross margins and net earnings. We have offset and expect to continue to mitigate in part the impact of these increased costs through internal cost reduction efforts, vendor negotiations, alternative sourcing options, and by recovering a portion of these costs with price increases to customers.

Service and Warranty

Our products are warranted to ensure customer confidence in design, workmanship, and overall quality. Warranty length varies depending on whether product usage is for residential or professional applications within individual product lines. Some products have an over-the-counter exchange option and some have a 30-day satisfaction guarantee. Warranty coverage ranges from a period of six months to seven years, and generally covers parts, labor, and other expenses for non-maintenance repairs, provided operator abuse, improper use, or negligence did not necessitate the repair. An authorized Toro, Lawn-Boy, Hayter, or Exmark distributor or dealer must perform warranty work. Distributors, dealers, and contractors submit claims for warranty reimbursement and are credited for the cost of repairs, labor, and other expenses as long as the repairs meet our prescribed standards. Warranty expense is accrued at the time of sale based on, among other factors, historical claims experience by individual product lines.

Warranty reserves are also accrued for major rework campaigns and product recalls. Service support outside of the warranty period is provided by independent Toro, Lawn-Boy, Hayter, or Exmark distributors and dealers at the customer's expense. We also sell extended warranty coverage on select products for a prescribed period after the original factory warranty period expires.

Product Liability

We have rigorous product safety standards and work continually to improve the safety and reliability of our products. We monitor accidents and possible claims and establish liability estimates with respect to claims based on internal evaluations of the merits of

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individual claims. We purchase excess insurance coverage for catastrophic product liability claims for incidents that exceed our self-insured retention levels.

Patents

We hold patents in the United States and foreign countries and apply for patents as applicable. Although we believe our patents are valuable and patent protection is beneficial, our patent protection does not deter or prevent competitors from attempting to develop similar products. We are not materially dependent on any one or more of our patents.

To prevent possible infringement of our patents by others, we periodically review competitors' products. To avoid potential liability with respect to others' patents, we regularly review certain patents issued by the U.S. Patent and Trademark Office and foreign patent offices. We believe these activities help us minimize our risk of being a defendant in patent infringement litigation. We are currently involved in patent litigation cases, both where we are asserting patents and where we are defending against charges of infringement. While the ultimate results of the current cases are unknown at this time, we believe that the outcome of these cases is unlikely to have a material effect on our consolidated financial results.

Seasonality

Sales of our residential products, which accounted for approximately 31 percent of total consolidated net sales in fiscal 2006, are seasonal, with sales of lawn and garden products occurring primarily between February and May, and sales of snow removal equipment occurring primarily between July and January. Opposite seasons in some global markets somewhat moderate this seasonality of residential product sales. Seasonality of professional product sales also exists, but is tempered because the selling season in the West Coast, Southern states, and our markets in the Southern hemisphere such as Australia, Latin America, and Asia continues for a longer portion of the year than in Northern regions of the world.

Overall, worldwide sales levels are historically highest in our fiscal second quarter and retail demand is generally highest in our fiscal third quarter. Typically, accounts receivable balances increase between January and April as a result of higher sales volumes and extended payment terms made available to our customers. Accounts receivable balances decrease between May and December when payments are received. Our financing requirements are subject to variations due to seasonal changes in working capital levels, which typically increase in the first half of our fiscal year and then decrease in the second half of our fiscal year. Seasonal cash requirements of our business are financed from operations and with our bank credit lines. Peak borrowing generally occurs between February and May.

The following table shows total consolidated net sales and net earnings for each quarter as a percentage of the total fiscal year.

Quarter	Fiscal 2006				Fiscal 2005			
	Net Sales		Net Earnings		Net Sales		Net Earnings	
First	20	%	11	%	20	%	10	%
Second	36		54		35		54	
Third	26		31		26		30	
Fourth	18		4		19		5	

Effects of Weather

From time to time, weather conditions in a particular region or market may adversely affect sales of some of our products and field inventory levels, and result in a negative impact on our future net sales. As the percentage of our net sales from outside the United States has continued to increase, our dependency on weather in any one part of the world has decreased. Nonetheless, weather conditions could materially affect our future net sales.

Distribution and Marketing

We market the majority of our products through approximately 50 domestic and 100 foreign distributors, as well as a number of hardware retailers, home centers, and mass retailers in more than 90 countries worldwide.

Toro and Lawn-Boy residential products, such as walk power mowers, riding products, and snow throwers, are sold to distributors, including Toro-owned distributors, for resale to retail dealers throughout the United States. Walk power mowers, snow throwers,

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and riding products are also sold directly to dealers, hardware retailers, home centers, and mass retailers. Home solutions products and retail irrigation products are primarily sold directly to home centers, mass retailers, hardware retailers, and dealers. We also sell selected residential products over the Internet, mainly through Internet retailers. Internationally, residential products are sold direct to retail dealers and mass merchandisers in Australia, Belgium, Canada, and the United Kingdom. In most other countries, products are main