

HEALTHSTREAM INC  
Form 10-Q  
October 31, 2011

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act  
of 1934**

**For the quarterly period ended September 30, 2011**

**Commission File No.: 000-27701**

**HealthStream, Inc.**

(Exact name of registrant as specified in its charter)

**Tennessee**

**62-1443555**

(State or other jurisdiction of  
incorporation or organization)

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

**209 10th Avenue South, Suite 450  
Nashville, Tennessee**

**37203**

(Address of principal executive offices)

(Zip Code)

**(615) 301-3100**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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

Smaller reporting  
company

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

As of October 27, 2011, 22,211,085 shares of the registrant's common stock were outstanding.

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements**

**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(In thousands)

	<b>September 30, 2011 (Unaudited)</b>	<b>December 31, 2010</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 30,236	\$ 17,868
Investments in short-term marketable securities		5,703
Restricted cash	15	85
Interest receivable		51
Accounts receivable, net of allowance for doubtful accounts of \$152 and \$157 at September 30, 2011 and December 31, 2010, respectively	13,141	11,069
Accounts receivable unbilled	1,117	1,314
Deferred tax assets, current	3,437	3,437
Prepaid royalties, net of amortization	1,913	3,145
Other prepaid expenses and other current assets	1,844	1,599
<b>Total current assets</b>	<b>51,703</b>	<b>44,271</b>
Property and equipment:		
Equipment	16,088	14,348
Leasehold improvements	4,048	2,738
Furniture and fixtures	2,384	2,027
	22,520	19,113
Less accumulated depreciation and amortization	(16,386)	(15,288)
	6,134	3,825
Capitalized software development, net of accumulated amortization of \$7,673 and \$5,887 at September 30, 2011 and December 31, 2010, respectively	7,746	4,333
Goodwill	21,147	21,147
Intangible assets, net of accumulated amortization of \$8,712 and \$8,043 at September 30, 2011 and December 31, 2010, respectively	2,175	2,844
Deferred tax assets, noncurrent	2,445	5,347
Other assets	85	244
<b>Total assets</b>	<b>\$ 91,435</b>	<b>\$ 82,011</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,302	\$ 2,375

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Accrued liabilities	4,123	4,121
Accrued compensation and related expenses	1,499	1,506
Deferred revenue	20,488	16,740
Capital lease obligations		4
Total current liabilities	27,412	24,746
Other long-term liabilities	458	474
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value, 75,000 shares authorized; 22,211 and 21,805 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	98,844	97,227
Accumulated deficit	(35,279)	(40,431)
Accumulated other comprehensive loss		(5)
Total shareholders' equity	63,565	56,791
Total liabilities and shareholders' equity	\$ 91,435	\$ 82,011

See accompanying notes to the condensed consolidated financial statements.

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**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**  
(In thousands, except per share data)

	<b>Three Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
Revenues, net	\$ 20,618	\$ 16,616
Operating costs and expenses:		
Cost of revenues (excluding depreciation and amortization)	7,915	6,274
Product development	1,946	1,750
Sales and marketing	3,810	3,358
Other general and administrative expenses	2,782	2,401
Depreciation and amortization	1,471	1,143
Total operating costs and expenses	17,924	14,926
Income from operations	2,694	1,690
Other income (expense):		
Interest and other income	5	4
Interest and other expense	(13)	(9)
Total other expense, net	(8)	(5)
Income before income tax provision	2,686	1,685
Income tax provision	890	889
Net income	\$ 1,796	\$ 796
Net income per share:		
Basic	\$ 0.08	\$ 0.04
Diluted	\$ 0.08	\$ 0.04
Weighted average shares of common stock outstanding:		
Basic	22,164	21,807
Diluted	23,496	22,511

See accompanying notes to the condensed consolidated financial statements.

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**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)**  
(In thousands, except per share data)

	<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
Revenues, net	\$ 60,175	\$ 48,114
Operating costs and expenses:		
Cost of revenues (excluding depreciation and amortization)	22,623	17,643
Product development	5,644	4,999
Sales and marketing	11,674	9,369
Other general and administrative expenses	8,009	6,885
Depreciation and amortization	3,868	3,769
 Total operating costs and expenses	 51,818	 42,665
 Income from operations	 8,357	 5,449
Other income (expense):		
Interest and other income	43	13
Interest and other expense	(35)	(31)
 Total other income (expense), net	 8	 (18)
 Income before income tax provision	 8,365	 5,431
Income tax provision	3,213	2,481
 Net income	 \$ 5,152	 \$ 2,950
 Net income per share:		
Basic	\$ 0.23	\$ 0.14
Diluted	\$ 0.22	\$ 0.13
 Weighted average shares of common stock outstanding:		
Basic	22,001	21,759
Diluted	23,272	22,358

See accompanying notes to the condensed consolidated financial statements.

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**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY (UNAUDITED)**  
**NINE MONTHS ENDED SEPTEMBER 30, 2011**  
(In thousands)

	<b>Common Stock</b>		<b>Accumulated</b>	<b>Accumulated Other Comprehensive</b>	<b>Total</b>
	<b>Shares</b>	<b>Amount</b>	<b>Deficit</b>	<b>(Loss)</b>	<b>Shareholders Equity</b>
Balance at December 31, 2010	21,805	\$ 97,227	\$ (40,431)	\$ (5)	\$ 56,791
Net income			5,152		5,152
Unrealized gain on investments in marketable securities				5	5
Stock based compensation expense		597			597
Exercise of stock options	406	1,020			1,020
Balance at September 30, 2011	22,211	\$ 98,844	\$ (35,279)	\$	\$ 63,565

See accompanying notes to the condensed consolidated financial statements.



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**HEALTHSTREAM, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)**  
(In thousands)

	Nine Months Ended September 30,	
	2011	2010
<b>OPERATING ACTIVITIES:</b>		
Net income	\$ 5,152	\$ 2,950
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,868	3,769
Stock based compensation expense	597	498
Deferred income taxes	2,902	2,338
Provision for doubtful accounts	45	20
Changes in operating assets and liabilities:		
Accounts and unbilled receivables	(1,920)	(1,366)
Restricted cash	70	23
Prepaid royalties	1,233	314
Other prepaid expenses and other current assets	(356)	(402)
Other assets	243	134
Accounts payable	(1,073)	(730)
Accrued liabilities and accrued compensation and related expenses and other long-term liabilities	(21)	(600)
Deferred revenue	3,748	4,869
Net cash provided by operating activities	14,488	11,817
<b>INVESTING ACTIVITIES:</b>		
Proceeds from maturities of investments in marketable securities	10,351	
Purchases of investments in marketable securities	(4,728)	
Payments associated with capitalized software development	(5,199)	(1,586)
Purchases of property and equipment	(3,560)	(850)
Net cash used in investing activities	(3,136)	(2,436)
<b>FINANCING ACTIVITIES:</b>		
Proceeds from exercise of stock options	1,020	469
Repurchase of common stock		(380)
Payments on note payable		(307)
Payments on capital lease obligations	(4)	(7)
Net cash provided by (used in) financing activities	1,016	(225)
Net increase in cash and cash equivalents	12,368	9,156
Cash and cash equivalents at beginning of period	17,868	12,287

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Cash and cash equivalents at end of period	\$ 30,236	\$ 21,443
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See accompanying notes to the condensed consolidated financial statements.

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The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ( US GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, condensed consolidated financial statements do not include all of the information and footnotes required by US GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. All significant intercompany transactions have been eliminated in consolidation. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011.

The balance sheet at December 31, 2010 is consistent with the audited financial statements at that date but does not include all of the information and footnotes required by US GAAP for a complete set of financial statements. For further information, refer to the consolidated financial statements and footnotes thereto for the year ended December 31, 2010 (included in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on March 23, 2011 and as amended on August 10, 2011).

**2. INCOME TAXES**

Income taxes are accounted for using the asset and liability method, whereby deferred tax assets and liabilities are determined based on the temporary differences between the financial statement and tax bases of assets and liabilities measured at tax rates that will be in effect for the year in which the differences are expected to affect taxable income. During the nine months ended September 30, 2011 and 2010, the Company recorded a provision for income taxes of \$3.2 million and \$2.5 million, respectively. The Company's effective tax rate for the nine months ended September 30, 2011 and 2010 was 38.4% and 45.7%, respectively. The Company's effective tax rate primarily reflects the statutory corporate income tax rate, the net effect of state taxes, and the effect of various immaterial permanent tax differences.

**3. STOCK BASED COMPENSATION**

The Company maintains two stock incentive plans. The Company accounts for its stock based compensation plans using the fair-value based method for costs related to share-based payments, including stock options. During the nine months ended September 30, 2011, the Company granted 362,750 stock options with a weighted average grant date fair value of \$4.67. During the nine months ended September 30, 2010, the Company granted 319,000 stock options with a weighted average grant date fair value of \$2.07. The fair value of stock based awards granted during the nine months ended September 30, 2011 and 2010 was estimated using the Black Scholes option pricing model, with the assumptions as follows:

	Nine Months Ended September 30,			
	2011		2010	
Risk-free interest rate	1.05	2.39%	2.39	2.49%
Expected dividend yield		0.0%		0.0%
Expected life	5	7 years	5	7 years
Expected forfeiture rate		0 5%		0 10%
Volatility		50%		55%

Total stock based compensation expense recorded for the three and nine months ended September 30, 2011 and 2010, which is recorded in the condensed consolidated statements of income, is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Cost of revenues (excluding depreciation and amortization)	\$ 9	\$ 9	\$ 29	\$ 28
Product development	34	32	110	96

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Sales and marketing	35	40	117	126
Other general and administrative	145	85	341	248
Total stock based compensation expense	\$ 223	\$ 166	\$ 597	\$ 498

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Basic net income per share is computed by dividing the net income available to common shareholders for the period by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing the net income for the period by the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares, composed of incremental common shares issuable upon the exercise of stock options and warrants, escrowed or restricted shares, and shares subject to vesting are included in diluted net income per share only to the extent these shares are dilutive. Common equivalent shares are dilutive when the average market price during the period exceeds the exercise price of the underlying shares. The total number of common equivalent shares excluded from the calculations of diluted net income per share, due to their anti-dilutive effect, was approximately 0.1 million and 0.3 million for the three and nine months ended September 30, 2011, respectively, and approximately 0.3 million and 0.5 million for the three and nine months ended September 30, 2010, respectively.

The following table sets forth the computation of basic and diluted net income per share for the three and nine months ended September 30, 2011 and 2010 (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Numerator:				
Net income	\$ 1,796	\$ 796	\$ 5,152	\$ 2,950
Denominator:				
Weighted average shares outstanding:				
Basic	22,164	21,807	22,001	21,759
Employee stock options	1,332	704	1,271	599
Diluted	23,496	22,511	23,272	22,358
Net income per share:				
Basic	\$ 0.08	\$ 0.04	\$ 0.23	\$ 0.14
Diluted	\$ 0.08	\$ 0.04	\$ 0.22	\$ 0.13

**5. COLLABORATIVE ARRANGEMENT**

On June 23, 2010, the Company announced the formation of SimVentures, a collaborative arrangement between HealthStream and Laerdal Medical Corporation (Laerdal Medical). The Company receives 50 percent of the profits or losses generated from this collaborative arrangement. The parties did not form a separate legal entity as part of the collaborative arrangement; therefore, the Company accounts for SimVentures as a collaborative arrangement in accordance with applicable accounting guidance. During the first quarter of 2011, the Company acquired a fifty percent ownership interest in Laerdal Medical's Advanced Video System (AVS) product for \$3.5 million in cash. AVS is a product that enables users of advanced patient simulators to easily capture video, audio, data logs, and patient responses. The AVS product is now jointly owned through SimVentures. During the second quarter of 2011, SimVentures launched SimStore, one of the components of SimCenter that offers healthcare providers an opportunity to sample and purchase simulation scenarios to use in their simulation training activities. During the nine months ended September 30, 2011, the Company recorded approximately \$0.5 million of revenues and \$0.9 million of

expenses related to the collaborative arrangement. The expenses are primarily recorded in the product development, sales and marketing and depreciation and amortization categories within the condensed consolidated statements of income. The Company also recorded approximately \$4.0 million of capitalized software development for SimVentures during 2011, comprised of the \$3.5 million paid for the AVS product and \$0.5 million associated with SimStore™.

#### **6. BUSINESS SEGMENTS**

The Company primarily provides services to healthcare organizations, and to a lesser extent, to pharmaceutical and medical device companies and other members within the healthcare industry. The Company's services are primarily focused on the delivery of education and training products and services (HealthStream Learning), as well as survey and research services (HealthStream Research). The accounting policies of the segments are the same as those described in the summary of significant accounting policies in the Company's Annual Report on Form 10-K, as amended, for the year ended December 31, 2010.

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The Company measures segment performance based on operating income before income taxes and prior to the allocation of certain corporate overhead expenses, interest income, interest expense, and depreciation. The following is the Company's business segment information as of and for the three and nine months ended September 30, 2011 and 2010 (in thousands).

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2011	2010	2011	2010
Revenues				
HealthStream Learning	\$ 14,805	\$ 11,527	\$ 42,248	\$ 33,070
HealthStream Research	5,813	5,089	17,927	15,044
Total net revenue	\$ 20,618	\$ 16,616	\$ 60,175	\$ 48,114
Income from operations				
HealthStream Learning	\$ 4,649	\$ 3,686	\$ 13,124	\$ 11,033
HealthStream Research	504	39	1,977	665
Unallocated	(2,459)	(2,035)	(6,744)	(6,249)
Total income from operations	\$ 2,694	\$ 1,690	\$ 8,357	\$ 5,449
Segment assets *			September 30, 2011	Decem