TWEETER HOME ENTERTAINMENT GROUP INC
Form 10-Q
February 09, 2006

Table of Contents

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

(Mark One)

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

For the quarterly period ended December 31, 2005

or

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

For the transition period from__________ to __________

Commission File Number: 0-24091

Tweeter Home Entertainment Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**04-3417513**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

40 Pequot Way
Canton, MA 02021
(Address of principal executive offices including zip code)
781-830-3000
(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 þ No o

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.

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date.

TITLE OF CLASS	**OUTSTANDING AT FEBRUARY 6, 2006**
Common Stock, $.01 par value	25,077,214

TWEETER HOME ENTERTAINMENT GROUP, INC. AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
TABLE OF CONTENTS

Table of Contents

PART 1 FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (Unaudited).

TWEETER HOME ENTERTAINMENT GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	December 31, 2005	September 30, 2005	December 31, 2004
ASSETS			
Current Assets:			
Cash and cash equivalents	$ 2,831,142	$ 1,309,871	$ 2,181,540
Accounts receivable, net of allowance for doubtful accounts of $1,395,379, $1,400,172 and $617,693, respectively	40,438,782	28,189,414	32,690,271
Inventory	129,350,864	111,506,056	130,276,341
Deferred tax assets			7,338,656
Refundable income taxes	8,906,841	9,006,740	
Prepaid expenses and other current assets	13,435,385	8,189,625	17,260,157
Total current assets	194,963,014	158,201,706	189,746,965
Property and equipment, net	112,058,621	115,306,933	126,882,908
Long-term investments	3,112,254	2,220,353	3,065,604
Deferred tax assets			11,792,841
Intangible assets, net	396,666	566,667	1,076,667
Goodwill	5,250,868	5,250,868	4,885,133
Other assets, net	2,267,469	2,470,599	2,150,451
Total Assets	$ 318,048,892	$ 284,017,126	$ 339,600,569
LIABILITIES AND STOCKHOLDERS EQUITY			
Current Liabilities:			
Current portion of long-term debt	$ 15,708,539	$ 9,278,849	$ 23,686,105
Current portion of deferred consideration	1,103,307	484,866	505,699
Accounts payable	37,531,699	34,885,458	39,175,677
Accrued expenses	55,716,731	48,775,158	39,862,346
Customer deposits	25,673,196	25,623,763	24,825,349
Deferred warranty			70,219
Total current liabilities	135,733,472	119,048,094	128,125,395
Long-term debt	65,055,686	62,617,263	35,791,036
Rent related accruals	16,859,175	16,939,556	11,186,122
Deferred consideration	2,424,330	2,545,547	2,909,196
Commitments and Contingencies			
Stockholders Equity:			
Preferred stock, $.01 par value, 10,000,000 shares authorized, no shares issued			
Common stock, $.01 par value, 60,000,000 shares authorized; 26,383,244, 26,249,725 and 26,196,193	263,832	262,497	261,962

shares issued, respectively			
Additional paid in capital	305,435,762	304,663,875	304,197,442
Unearned equity compensation			(31,983)
Accumulated other comprehensive income	123,716	112,329	96,902
Accumulated deficit	(206,175,310)	(220,488,691)	(141,194,308)
Treasury stock, 1,561,165, 1,577,698 and 1,660,343 shares, at cost, respectively	(1,671,771)	(1,683,344)	(1,741,195)
Total stockholders equity	97,976,229	82,866,666	161,588,820
Total Liabilities and Stockholders Equity	$ 318,048,892	$ 284,017,126	$ 339,600,569

See notes to unaudited condensed consolidated financial statements.

2

Table of Contents

TWEETER HOME ENTERTAINMENT GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

	Three Months Ended December 31, 2005	Three Months Ended December 31, 2004
Total revenue	$ 266,519,474	$ 258,222,884
Cost of sales	(157,282,481)	(154,463,236)
Gross profit	109,236,993	103,759,648
Selling, general and administrative expenses	93,660,208	94,113,170
Amortization of intangibles	170,000	170,000
Restructuring charges	83,243	
Income from continuing operations	15,323,542	9,476,478
Interest expense	(1,386,991)	(543,800)
Interest income	36	13,434
Income from continuing operations before income taxes	13,936,587	8,946,112
Income tax provision	100,000	3,578,445
Income from continuing operations before income from equity investments	13,836,587	5,367,667
Income from equity investments	695,647	268,711
Net income from continuing operations	14,532,234	5,636,378
Discontinued operations:		
Pre-tax loss from discontinued operations	(218,853)	(1,157,724)
Income tax benefit		(463,090)
Net loss from discontinued operations	(218,853)	(694,634)
Net income	$ 14,313,381	$ 4,941,744
Basic earnings per share:		
Income from continuing operations	$ 0.59	$ 0.23
Loss from discontinued operations	(0.01)	(0.03)
Basic net income per share	$ 0.58	$ 0.20
Diluted earnings per share:		
Income from continuing operations	$ 0.59	$ 0.23
Loss from discontinued operations	(0.01)	(0.03)
Diluted net income per share	$ 0.58	$ 0.20
Weighted average shares outstanding:		
Basic	24,731,264	24,456,033

Diluted	24,845,671	24,737,778

See notes to unaudited condensed consolidated financial statements.

3

Table of Contents

TWEETER HOME ENTERTAINMENT GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three Months Ended December 31, 2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 14,313,381	$ 4,941,744
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	6,287,490	6,134,969
Stock-based compensation vendor	191,000	
Stock-based compensation employee	169,375	43,744
Income from equity investment	(695,647)	(447,852)
Loss (gain) on disposal of property and equipment	60,820	(8,250)
Allowance for doubtful accounts	20,697	157,426
Tax benefit from options exercised		12,659
Deferred income tax provision		3,153,436
Amortization of deferred gain on sale leaseback	(11,211)	(11,211)
Impairment charge	140,183	
Recognition of deferred lease incentives	(166,911)	
Changes in operating assets and liabilities:		
Increase in accounts receivable	(12,270,065)	(15,051,775)
Increase in inventory	(18,022,082)	(23,732,070)
Increase in prepaid expenses and other assets	(5,063,714)	(1,078,764)
Increase in accounts payable and accrued expenses	10,706,141	9,011,931
Increase in customer deposits	49,433	2,931,444
Decrease in deferred warranty		(23,406)
Increase in rent related accruals	90,148	125,944
Increase (decrease) in deferred consideration	497,224	(133,717)
Net cash used in operating activities	(3,703,738)	(13,973,748)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(4,067,524)	(7,834,892)
Proceeds from sale of property and equipment		8,250
Purchase of equity investments		(300,000)
Net cash used in investing activities	(4,067,524)	(8,126,642)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net change in amount due to bank	6,430,757	20,510,427
Net proceeds of long-term debt	2,437,356	780,510
Proceeds from options exercised	344,036	95,284
Proceeds from employee stock purchase plan	80,384	94,704
Net cash provided by financing activities	9,292,533	21,480,925
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,521,271	(619,465)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	1,309,871	2,801,005

CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 2,831,142	$ 2,181,540

See notes to unaudited condensed consolidated financial statements.

4

Table of Contents

TWEETER HOME ENTERTAINMENT GROUP, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The unaudited condensed consolidated financial statements of Tweeter Home Entertainment Group, Inc. and its subsidiaries (Tweeter or the Company), included herein, should be read in conjunction with the consolidated financial statements and notes thereto included in Tweeter s Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

2. Summary of Selected Accounting Policies

The unaudited interim condensed consolidated financial statements of Tweeter have been prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, all adjustments (consisting only of normal and recurring adjustments) considered necessary for a fair presentation of the interim condensed consolidated financial statements have been included. Operating results for the three-month period ended December 31, 2005 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2006. Tweeter typically records its highest revenue and income in its first fiscal quarter.

Rent Related Accruals Rent expense under non-cancelable operating leases is recorded on a straight-line basis over the lease term, including build-out period. The build-out period typically ranges from 90 to 120 days prior to the store opening. The excess straight-line rent expense over scheduled payment amounts is recorded as a deferred liability. Net gains from sale-leaseback transactions are initially deferred and then amortized over the lease term. Losses from sale-leaseback transactions are fully recognized in the period in which they occur.

Advertising Gross advertising includes costs for advertising in electronic media, newspaper, buyer s guides and direct mailings. Such costs are expensed when the media is first released. Cooperative advertising represents monies received from suppliers for specific advertising activities, under the guidelines expressed in Emerging Issues Task Force (EITF) 02-16, which reduces gross advertising expense. Below are the gross advertising expenses, cooperative advertising funds received and net advertising expenses for the three months ended December 31, 2005 and 2004.

	Three Months Ended December 31,	
	2005	**2004**
Gross advertising expenses	$ 15,313,161	$ 19,660,792
Cooperative advertising funds received	(201,660)	(6,589)
Net advertising expenses	$ 15,111,501	$ 19,654,203

Stock-based compensation In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), *Share-Based Payment* (Statement 123(R)), which requires the recognition of the cost of employee services received in exchange for an award of equity instruments in the financial statements and measurement based on the grant-date fair value of the award. It also requires the cost to be recognized over the period during which an employee is required to provide service in exchange for the award (presumptively the vesting period). Statement 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and its related interpretations. The Company adopted Statement 123(R) on October 1, 2005. The Company chose the Modified Prospective Application (MPA) method for implementing Statement 123(R). Under the MPA method, new awards are valued and accounted for prospectively upon adoption. Outstanding prior awards that are unvested as of October 1, 2005 will be recognized as compensation cost over the remaining requisite service period. Prior periods will not be restated.

Table of Contents

Adoption of Statement 123(R) did not affect the Company s cash flow or financial position but it did reduce its reported net income and earnings per share, since adopting Statement 123(R) results in the Company recording compensation cost for employee stock options and employee share purchase rights.

On September 30, 2005 the Board of Directors approved the full acceleration of the vesting of each otherwise unvested outstanding stock option granted under the Company s 1995 and 1998 Stock Option and Incentive Plans and its 2004 Long Term Incentive Plan for those grants whose strike price was higher than the closing market value of a share of the Company s common stock on that date. As a result, options to purchase approximately 867,000 shares, including approximately 374,000 options held by the Company s executive officers and directors, became immediately exercisable effective as of September 30, 2005.

The decision to accelerate vesting of these options was made primarily to minimize future compensation expense that the Company would otherwise recognize in its consolidated statements of operations upon the effectiveness of Statement 123(R). As a result of the acceleration, the Company expects to reduce the stock option expense it otherwise would be required to record in connection with accelerated options by approximately $2.0 million in 2006, $653,000 in 2007 and $63,000 in 2008 under MPA.

Prior to its adoption of Statement 123(R) the Company accounted for stock-based compensation in compliance with APB 25, which addressed the financial accounting and reporting standards for stock or other equity-based compensation arrangements. The Company accounted for stock based compensation to employees using the intrinsic method. The Company provided disclosures based on the fair value as permitted by SFAS No. 123. Stock or other equity-based compensation for non-employees was accounted for under the fair value-based method as required by SFAS No. 123 and EITF No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*, and other related interpretations. Under this method, the equity-based instrument was valued at either the fair value of the consideration received or the equity instrument issued on the date of grant. The resulting compensation cost was recognized and charged to operations over the service period, which was usually the vesting period.

The Company included $169,375 in total stock-based compensation expense to employees in its condensed consolidated statement of operations for the three months ended December 31, 2005 as a result of the adoption of Statement 123(R). Prior to the adoption of Statement No. 123(R), the Company reported all tax benefits resulting from the exercise of non-qualified stock options as operating cash flows in its consolidated statements of cash flows. In accordance with Statement No. 123(R), the Company revised its current year statement of cash flows presentation to report the excess tax benefits from the exercise of non-qualified stock options as financing cash flows. There were $0 of excess tax benefits from the exercise of non-qualified stock options for the three months ended December 31, 2005.

For purposes of determining the disclosures required by Statement No. 123(R), the fair values of each stock option granted under the Company s stock option plan and shares subject to purchase under the Employee Stock Purchase Plan (ESPP) in the three months ended December 31, 2005 were estimated on the date of grant and beginning of ESPP period, respectively, using the Black-Scholes option-pricing model. The weighted average grant date fair value of all stock option grants issued and ESPP shares for the three months ended December 31, 2005 was $1.93 and $1.45, respectively, using the following assumptions:

Table of Contents

	Three Months Ended December 31, 2005 Stock Option Plan	ESPP
Risk-free interest rate	4.24%	3.47%
Expected dividend yield	0.00%	0.00%
Expected life of option grants and ESPP shares (years)	4.33	0.25
Expected volatility of underlying stock	75.8%	89.3%
Expected forfeitures as percentage of total option grants and ESPP shares	7.0%	0.0%

The risk-free rates for the stock option plan and ESPP are the weighted average of the yield rates on 5-year U.S. Treasury notes on the dates of the stock option grants and the yield rates on 3-month U.S. Treasury bills at the inception of each quarterly ESPP period, respectively. The dividend yield of zero is based on the fact that the Company has never paid cash dividends and has no present intention to pay cash dividends. The expected life of the option grants is based on the Company s analysis of its experience with its option grants. The expected life of the ESPP shares is 0.25 years, since shares are purchased through the plan on a quarterly basis. Expected volatility is based on the historical volatility of the Company s common stock over the period commensurate with the expected life of the options and the ESPP shares, respectively. The expected forfeitures as a percentage of total grants are based on the Company s analysis of its experience with its option grants. The expected forfeitures as a percentage of total ESPP shares are zero due to the short-term nature of the plan. Under the true-up provisions of Statement 123(R) additional expense will be recorded if the actual forfeiture rate is lower than estimated and a recovery of prior expense will be recorded if the actual forfeiture rate is higher than estimated.

SFAS No. 123 requires the presentation of pro forma information for the comparative period prior to the adoption as if all of the Company s employee stock options had been accounted for under the fair value method of the original SFAS No. 123. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation in the prior-year period.

		Three Months Ended December 31, 2004
Net income as reported	$	4,941,744
Add:		
Total stock-based employee compensation expense recorded, net of related tax effects		26,246
Deduct:		
Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(1,182,487)
Pro forma net income	$	3,785,503
Earnings per share		
Basic and diluted as reported	$	0.20
Basic and diluted pro forma	$	0.15

For purposes of determining the disclosures required by SFAS No. 123, the fair value of each stock option granted in the three months ended December 31, 2004 under the Company s stock option plan was estimated on the date of grant using the Black-Scholes option-pricing model. The weighted average grant date fair value of all stock option grants issued for the three months ended December 31, 2004 was $3.42, using the following assumptions:

Table of Contents

	Three Months Ended December 31, 2004
Risk-free interest rate	3.35%
Expected dividend yield	0.00%
Expected life of option grants (years)	4.33
Expected volatility of underlying stock	83.2%
Expected forfeitures as percentage of total grants	7.0%

During the three months ended December 31, 2005 the Company recorded stock-based compensation expense of $191,000 representing the value of common stock issued to a vendor.

3. Restructuring Charges

During the third quarter of fiscal year 2005, the Company initiated a restructuring plan designed to close 19 underperforming stores and re-align its resources and cost structure.

Thirteen of the closed stores were in markets where the Company continues to have a presence and accordingly, the results of their operations are included in continuing operations. The Company completed 12 of these store closings by June 28, 2005 and the remaining store closed on October 30, 2005. In fiscal year 2005 the Company recorded restructuring charges associated with these store closings totaling $16,563,514, including $6,331,402 of non-cash charges, principally related to impairment of fixed assets. In the first quarter of fiscal year 2006 the Company recorded a change in estimated costs associated with these store closings totaling $83,243. At December 31, 2005 the Company had accrued expenses associated with these store closings totaling $5,568,803, which the Company believes is adequate to cover charges associated with the remaining lease terminations and professional fees.

In accounting for restructuring charges, the Company complied with SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred.

The following is a summary of restructuring charge activity for the three months ended December 31, 2005:

	Termination and Other Related Charges	Professional Fees	Severance	Total
Balance as of September 30, 2005	$ 6,394,552	$ 928,564	$ 8,992	$ 7,332,108
Change in estimate revised assumptions	83,243			83,243
Payments	(1,725,959)	(111,597)	(8,992)	(1,846,548)
Balance as of December 31, 2005	$ 4,751,836	$ 816,967	$	$ 5,568,803

Lease termination and other related charges represent lease termination costs and accrued rent on certain closed stores. Professional fees include amounts paid to third parties in connection with the negotiation of lease terminations and with the liquidation of inventory for the closed stores. Non-cash charges include write-off of leasehold improvements and reversal of deferred lease incentives related to the closed stores.

4. Discontinued Operations

In the third quarter of fiscal year 2005, as part of the restructuring plan described in Note 3, the Company closed or committed to close six stores in markets where the Company does not continue to have a presence. The Company completed these store closings by July 31, 2005. In fiscal year 2005 the Company recorded exit costs associated with these six store closings within discontinued operations totaling $6,291,420, including $2,012,280 of non-cash

charges, principally related to impairment of fixed assets. Previously, in the fourth quarter of fiscal year 2004 the Company closed, sold or committed to close eight stores, all of which were closed by December 31, 2004. The Company recorded a change in estimated costs associated with all these store closings totaling $218,853 and $150,720 for the three months ended December 31, 2005 and December 31, 2004, respectively, consisting of lease termination and other rent related charges. At December 31, 2005 the Company had accrued expenses associated with these store closings totaling $1,984,887, which the Company believes is adequate to cover charges associated with the remaining lease terminations and professional fees for the stores closed in fiscal year 2005.

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company classified the operating results of these stores as discontinued operations in the accompanying consolidated statements of operations. Prior year information has been reclassified to conform to current year presentation. Revenue from the closed stores amounted to $4,236,999 for the three months ended December 31, 2004. There was no revenue from the closed stores for the three months ended December 31, 2005.

	Lease Termination and Other Related Charges	Professional Fees	Severance	Total
Balance as of September 30, 2005	$ 1,565,310	$ 530,885	$ 6,653	$ 2,102,848
Change in estimate revised assumptions	218,853			218,853
Payments	(203,640)	(126,521)	(6,653)	(336,814)
Balance as of December 31, 2005	$ 1,580,523	$ 404,364	$	$ 1,984,887

Lease termination and other related charges represent lease termination costs and accrued rent on certain closed stores. Professional fees include amounts paid to third parties in connection with the negotiation of lease terminations and with the liquidation of inventory for the closed stores. Non-cash charges include write-off of leasehold improvements and reversal of deferred lease incentives related to the closed stores.

5. Income Taxes

SFAS No. 109, *Accounting for Income Taxes*, requires the Company to provide a valuation allowance when it is more likely than not that some portion or all of the deferred tax assets will not be realized. In March 2005 the Company recorded a full valuation allowance and has continued to record such an allowance through December 31, 2005 based upon its determination that it was more likely than not that it would not realize the deferred tax benefits related to those assets. The Company based that determination, in part, on its prior three years of losses and consideration of store closings. As of December 31, 2005 the Company provided a valuation allowance of approximately $39.9 million related to net federal and state deferred tax assets. In future periods the Company will re-evaluate the likelihood of realizing benefits from the deferred tax assets and adjust the valuation allowance as deemed necessary. Further, based on the availability of net operating losses being carried forward, the Company did not record any federal tax provision on fiscal year 2006 income but has provided a provision for certain state tax exposures.

6. Net Income per Share

Basic earnings (loss) per share are calculated based on the weighted average number of common shares outstanding. Diluted earnings (loss) per share are based on the weighted average number of common shares outstanding plus dilutive potential common shares (common stock options and warrants). Common stock options and warrants are not included in the earnings (loss) per share calculation when their exercise price is greater than the average market price for the period.

The following is a reconciliation of the weighted average shares outstanding for basic and diluted earnings per share from continuing operations:

	Three Months Ended December 31,	
	2005	**2004**
Basic Earnings Per Share:		
Numerator:		
Net income from continuing operations	$ 14,532,234	$ 5,636,378
Denominator:		
Weighted-average shares outstanding	24,731,264	24,456,033
Basic net income per share	$ 0.59	$ 0.23
Diluted Earnings Per Share:		
Numerator:		
Net income from continuing operations	$ 14,532,234	$ 5,636,378
Denominator:		
Weighted-average shares outstanding	24,845,671	24,737,778