TALK AMERICA HOLDINGS INC
Form 10-Q
August 04, 2004

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2004

OR

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

For the transition period from _____ to _____

Commission file number 000 - 26728

Talk America Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**23-2827736**
(State of incorporation)	(I.R.S. Employer Identification No.)

12020 Sunrise Valley Drive, Suite 250, Reston, Virginia	**20191**
(Address of principal executive offices)	(Zip Code)

(703) 391-7500
(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 X No____

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes X No____

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

26,972,408 shares of Common Stock, par value of $0.01 per share, were issued and outstanding as of August 2, 2004.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES

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TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except for per share data)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Revenue	$ 114,881	$ 93,748	$ 224,202	$ 181,591
Costs and expenses:				
Network and line costs, excluding depreciation and amortization (see below)	55,586	43,268	109,806	87,152
General and administrative expenses	15,891	12,549	31,053	25,428
Provision for doubtful accounts	4,905	2,895	8,326	5,117
Sales and marketing expenses	19,204	11,629	36,488	21,000
Depreciation and amortization	5,322	4,380	10,453	8,688
Total costs and expenses	100,908	74,721	196,126	147,385
Operating income	13,973	19,027	28,076	34,206
Other income (expense):				
Interest income	42	186	143	295
Interest expense	(442)	(2,027)	(1,259)	(4,506)
Other income, net	--	314	--	2,465
Income before provision for income taxes	13,573	17,500	26,960	32,460
Provision for income taxes	5,025	6,825	10,056	12,659
Net income	$ 8,548	$ 10,675	$ 16,904	$ 19,801
Income per share Basic:				
Net income per share	$ 0.32	$ 0.41	$ 0.63	$ 0.75
Weighted average common shares outstanding	26,746	26,226	26,710	26,300
Income per share Diluted:				
Net income per share	$ 0.30	$ 0.37	$ 0.59	$ 0.69
Weighted average common and common equivalent shares outstanding	28,694	29,562	28,787	29,345

See accompanying notes to consolidated financial statements.

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TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except for share and per share data)
(Unaudited)

		June 30, 2004		December 31, 2003
Assets				
Current assets:				
Cash and cash equivalents	$	30,427	$	35,242
Accounts receivable, trade (net of allowance for uncollectible accounts of $12,227 and $9,414 at June 30, 2004 and December 31, 2003, respectively)		48,109		40,321
Deferred income taxes		26,338		24,605
Prepaid expenses and other current assets		7,476		5,427
Total current assets		112,350		105,595
Property and equipment, net		66,016		68,069
Goodwill		19,503		19,503
Intangibles, net		3,244		4,666
Deferred income taxes		30,619		40,543
Other assets		8,264		7,547
	$	239,996	$	245,923
Liabilities and Stockholders Equity				
Current liabilities:				
Accounts payable	$	43,039	$	35,296
Sales, use and excise taxes		14,926		14,551
Deferred revenue		14,516		10,873
Current portion of long-term debt		17,554		16,806
Accrued compensation		4,941		9,888
Other current liabilities		4,188		7,027
Total current liabilities		99,164		94,441
Long-term debt		2,985		31,791
Deferred income taxes		19,840		19,904
Commitments and contingencies				
Stockholders' equity:				
Preferred stock - $.01 par value, 5,000,000 shares authorized; no shares outstanding		--		--
Common stock - $.01 par value, 100,000,000 shares authorized; 26,966,743 and 26,662,952 issued and outstanding at June 30, 2004 and December 31, 2003, respectively		283		280
Additional paid-in capital		356,160		354,847
Accumulated deficit		(233,436)		(250,340)

Treasury stock - $.01 par value, 1,315,789 shares at June 30,2004 and December 31, 2003, respectively	(5,000)	(5,000)
Total stockholders' equity	118,007	99,787
	$ 239,996	$ 245,923

See accompanying notes to consolidated financial statements.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)
(Unaudited)

	Common Stock				Treasury Stock		
	Shares	Amount	Additional Paid-In Capital	Accumulated Deficit	Shares	Amount	Total
Balance, December 31, 2003	27,979	$280	$354,847	$(250,340)	1,316	$(5,000)	$99,787
Net income	--	--	--	16,904	--	--	16,904
Income tax benefit related to exercise of common stock options	--	--	757	--	--	--	757
Change in terms of employee stock options	--	--	9	--	--	--	9
Exercise of common stock options	304	3	547	--	--	--	550
Balance, June 30, 2004	28,283	$283	$356,160	$(233,436)	1,316	$(5,000)	$118,007

See accompanying notes to consolidated financial statements.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended June 30,	
	2004	**2003**
Cash flows from operating activities:		
Net income	$ 16,904	$ 19,801
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for doubtful accounts	8,326	5,117
Depreciation and amortization	10,453	8,687
Loss on sale and retirement of assets	--	16
Non-cash compensation	9	--
Non-cash interest and amortization of accrued interest liabilities	(130)	(131)
Gain from extinguishment of debt	--	(2,471)
Deferred income taxes	8,884	11,647
Changes in assets and liabilities:		
Accounts receivable, trade	(16,114)	(11,180)
Prepaid expenses and other current assets	(1,488)	(551)
Other assets	(24)	1,435
Accounts payable	7,743	2,321
Sales, use and excise taxes	375	1,354
Deferred revenue	3,643	2,227
Accrued compensation	(4,947)	(1,345)
Other current liabilities	(2,839)	(1,843)
Net cash provided by operating activities	30,795	35,084
Cash flows from investing activities:		
Capital expenditures	(3,339)	(4,217)
Capitalized software development costs	(1,787)	(1,388)
Net cash used in investing activities	(5,126)	(5,605)
Cash flows from financing activities:		
Payments of borrowings	(30,362)	(32,676)
Payments of capital lease obligations	(672)	(31)
Proceeds from exercise of options	550	498
Purchase of treasury stock	--	(5,000)
Net cash used in financing activities	(30,484)	(37,209)
Net decrease in cash and cash equivalents	(4,815)	(7,730)

Cash and cash equivalents, beginning of period		35,242		33,588
Cash and cash equivalents, end of period	$	30,427	$	25,858

See accompanying notes to consolidated financial statements.

TALK AMERICA HOLDINGS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. ACCOUNTING POLICIES

(a) Basis of Financial Statements Presentation

The consolidated financial statements include the accounts of Talk America Holdings, Inc. and its wholly-owned subsidiaries (collectively, "Talk America," "we," "our" and "us"). All intercompany balances and transactions have been eliminated.

The consolidated financial statements and related notes thereto as of June 30, 2004 and for the three and six months ended June 30, 2004 and June 30, 2003 are presented as unaudited, but in the opinion of management include all adjustments necessary to present fairly the information set forth therein. The consolidated balance sheet information for December 31, 2003 was derived from the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2003 filed March 12, 2004, as amended by our Form 10-K/A filed May 7, 2004. These interim financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2003, as amended by our Form 10-K/A. The interim results are not necessarily indicative of the results for any future periods. Certain prior year amounts have been reclassified for comparative purposes.

(b) Risks and Uncertainties

Future results of operations involve a number of risks and uncertainties. Factors that would likely negatively affect future operating results and cash flows and cause actual results to vary materially from historical results include, but are not limited to:

- Dependence on the availability and functionality of the networks of the incumbent local telephone carriers as they relate to the unbundled network element platform
- The FCC is expected to pronounce interim and eventually final rules with respect thereto, which are expected to adversely affect availability and pricing of various network elements and bundles thereof. Such rules may also affect or limit our ability to pursue our current customer first strategy of acquiring a base of bundled phone service customers, building our own network platform and the migrating those customers to our own network platform.
- Additional changes in government policy, regulation and enforcement or adverse judicial or administrative interpretations and rulings or legislative action relating to regulations, enforcement and pricing.
- Increased price competition in local and long distance services, including bundled services, and overall competition within the telecommunications industry.

Further negative developments in these areas would likely have a material adverse effect on our business prospects, financial condition and results of operations. See Other Matters .

NOTE 2. DEBT AND CAPITAL LEASE OBLIGATIONS

The following is a summary of our debt and capital lease obligations (in thousands):

	June 30, 2004	December 31, 2003
12% Senior Subordinated Notes Due 2007	$ 10,730	$ 40,730
8% Convertible Senior Subordinated Notes Due 2007 (1)	3,648	3,778
5% Convertible Subordinated Notes Due 2004	670	670
Other, primarily vendor-financed computer software	2,744	0
Capital lease obligations	2,747	3,419
Total long-term debt and capital lease obligations	20,539	48,597
Less: current maturities (2)	17,554	16,806
Total long-term debt and capital lease obligations, excluding current maturities	$ 2,985	$ 31,791

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(1) Includes future accrued interest of $0.8 million as of June 30, 2004 and $1.0 million as of December 31, 2003.

(2) Reflects our June 21, 2004, notice and commitment to redeem remaining principal amounts of our 12% Senior Subordinated Notes and our 8% Convertible Senior Subordinated Notes, respectively, on August 23, 2004, and resulting change in the maturity of such principal amount to the noticed redemption date.

(a) 12% Senior Subordinated Notes Due 2007 and 8% Convertible Senior Subordinated Notes Due 2007

Effective April 4, 2002, we completed the exchange of $57.9 million of the $61.8 million outstanding principal balance of our 4-1/2% Convertible Subordinated Notes due December 15, 2002 ("4-1/2% Convertible Subordinated Notes") for $53.2 million principal amount of our new 12% Senior Subordinated PIK Notes due August 2007 ("12% Senior Subordinated Notes") and $2.8 million principal amount of our new 8% Convertible Senior Subordinated Notes due August 2007 ("8% Convertible Senior Subordinated Notes") and cash paid of $0.5 million. In addition, we exchanged $17.4 million of the $18.1 million outstanding principal balance of our 5% Convertible Subordinated Notes ("5% Convertible Subordinated Notes") that mature on December 15, 2004 for $17.4 million principal amount of the 12% Senior Subordinated Notes.

On June 21, 2004, we provided a notice and commitment to redeem the remaining principal amounts of our 12% Senior Subordinated Notes and our 8% Convertible Senior Subordinated Notes on August 23, 2004. The 12% Senior Subordinated Notes and 8% Convertible Senior Subordinated Notes are redeemable at any time at our option at par value plus accrued interest to the redemption date.

In accordance with SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," we accounted for the exchange of the 4-1/2% Convertible Subordinated Notes for $53.2 million of the 12% Senior Subordinated Notes and $2.8 million of the 8% Convertible Senior Subordinated Notes as a troubled debt restructuring. Since the total liability of $57.4 million ($57.9 million of principal as of the exchange date, less cash payments of $0.5 million) was less than the future cash flows to holders of 8% Convertible Senior Subordinated Notes and 12% Senior Subordinated Notes of $91.5 million (representing the $56.0 million of principal and $35.5 million of future interest expense), the liability remained on our balance sheet at $57.4 million as long-term debt. We recognized the difference of $1.4 million between principal and the carrying amount as a reduction of interest expense over the life of the new notes. The redemption of the 8% Convertible Senior Subordinated Notes prior to maturity will cause $0.8 million of future accrued interest benefit to be recorded as an offset to interest expense upon redemption.

(b) 5% Convertible Subordinated Notes Due 2004

As of June 30, 2004, we had $0.7 million principal amount outstanding of our 5% Convertible Subordinated Notes that mature on December 15, 2004. The notes are convertible, at the option of the holder, at a conversion price of $76.14 per share. The 5% Convertible Subordinated Notes are redeemable, in whole or in part at our option, at 100.71% of par.

(c) Other

During the second quarter 2004, we entered into a vendor-financed computer software purchase agreement for upgrades to our database management systems. Approximately $2.7 million was outstanding under this agreement at June 30, 2004. Total assets under this purchase agreement are approximately $3.4 million as of June 30, 2004, consisting of a perpetual software license agreement of approximately $2.9 million and a one-year vendor maintenance agreement of approximately $0.5 million. The agreement is repayable in 12 quarterly installments, which includes interest based on an annual percentage rate of approximately 3% and annual maintenance agreement renewals.

(d) Capital Leases

During 2003, we entered into a non-cancelable capital lease agreement for upgrades to our customer data storage equipment. Approximately $2.7 million and $3.4 million was outstanding under this agreement at June 30, 2004 and December 31, 2003, respectively. Total assets under this lease agreement are approximately $3.4 million as of June 30, 2004 and December 31, 2003. The lease is repayable in monthly installments through December 2006, which includes interest based on an annual percentage rate of approximately 2%.

NOTE 3. COMMITMENTS AND CONTINGENCIES

We are party to a number of legal actions and proceedings arising from our provision and marketing of telecommunications services (including matters involving do not call regulations), as well as certain legal actions and regulatory matters arising in the ordinary course of business. During the second quarter of 2003, we were made aware that AOL agreed to settle a class action case for approximately $10 million; the claims in the case allegedly relate to marketing activities conducted pursuant to the former telecommunications marketing agreement, between us and AOL. At the time of the settlement agreement, AOL asserted that we are required to indemnify AOL in this matter under the terms of the marketing agreement and advised that it will seek such indemnification from us. We believe that we do not have an obligation to indemnify AOL in this matter and that any claim by AOL for this indemnification would be without merit. We have received no further information regarding this matter and it is our intention, if AOL initiates a claim for indemnification under the marketing agreement, to defend against the claim vigorously. We believe that the ultimate outcome of the foregoing actions will not result in a liability that would have a material adverse effect on our financial condition or results of operations.

NOTE 4. STOCK-BASED COMPENSATION

We account for our stock option awards under the intrinsic value based method of accounting prescribed by APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, including FASB Interpretation No. 44 "Accounting for Certain Transactions Including Stock Compensation," an interpretation of APB Opinion No. 25. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. We make pro forma disclosures of net income and earnings per share as if the fair value based method of accounting had been applied as required by SFAS No. 123, "Accounting for Stock-Based Compensation" and SFAS 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of SFAS 123. The following disclosure complies with the adoption of this statement and includes pro forma net income as if the fair value based method of accounting had been applied (in thousands except for per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Net income as reported	$ 8,548	$ 10,675	$ 16,904	$ 19,801
Add: Stock-based employee compensation expense included in reported net income	9	--	9	--
Deduct: Total stock-based employee compensation expense determined under fair value based method for all options	1,482	340	2,961	562
Pro forma net income	$ 7,075	$ 10,335	$ 13,952	$ 19,239

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Basic earnings per share:				
As reported	$ 0.32	$ 0.41	$ 0.63	$ 0.75
Pro forma	$ 0.25	$ 0.37	$ 0.49	$ 0.69
Diluted earnings per share:				
As reported	$ 0.30	$ 0.37	$ 0.59	$ 0.69
Pro forma	$ 0.25	$ 0.36	$ 0.49	$ 0.68

For purposes of pro forma disclosures under SFAS 123, the estimated fair value of the options is assumed to be amortized to expense over the options' vesting period. The fair value of the options granted has been estimated at the various dates of the grants using the Black-Scholes option-pricing model with the following assumptions:

- Fair market value based on our closing common stock price on the date the option is granted;
- Risk-free interest rate based on the weighted averaged 5 year U.S. treasury note strip rates;
- Volatility based on the historical stock price over the expected term (5 years);
- No expected dividend yield based on future dividend payment plans.

NOTE 5. PER SHARE DATA

Basic earnings per common share for a fiscal period is calculated by dividing net income by the weighted average number of common shares outstanding during the fiscal period. Diluted earnings per common share is calculated by adjusting the weighted average number of common shares outstanding and the net income during the fiscal period for the assumed conversion of all potentially dilutive stock options, warrants and convertible bonds (and assuming that the proceeds hypothetically received from the exercise of dilutive stock options are used to repurchase our common stock at the average share price during the fiscal period). For the diluted earnings calculation, we also adjust the net income by the interest expense on the convertible bonds assumed to be converted. Income per share is computed as follows (in thousands except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Net income used to compute basic earnings per share	$ 8,548	$ 10,675	$ 16,904	$ 19,801
Interest expense on convertible bonds, net of tax affect (See Note 2 (a))	(5)	183	(11)	366
Net income used to compute diluted earnings per share	$ 8,543	$ 10,858	$ 16,893	$ 20,167
Average shares of common stock outstanding used to compute basic earnings per share	26,746	26,226	26,710	26,300
Additional common shares to be issued assuming exercise of stock options and warrants (net of shares assumed reacquired) and conversion of convertible bonds *	1,948	3,336	2,077	3,045
Average shares of common and common equivalent stock outstanding used to compute diluted earnings per share	28,694	29,562	28,787	29,345
Income per share Basic:				
Net income per share	$ 0.32	$ 0.41	$ 0.63	$ 0.75
Weighted average common shares outstanding	26,746	26,226	26,710	26,300
Income per share Diluted:				
Net income per share	$ 0.30	$ 0.37	$	