HEALTHWAYS, INC
Form 10-Q
May 09, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended March 31, 2013

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 000-19364

HEALTHWAYS, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	62-1117144 (I.R.S. Employer Identification No.)

701 Cool Springs Boulevard, Franklin, TN 37067
(Address of Principal Executive Offices) (Zip Code)

615-614-4929
(Registrant's Telephone Number, Including Area Code)

(Former name, former address and former fiscal year, if changed since last report)

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 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 (§

232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x 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 x
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 x

As of May 6, 2013, there were outstanding 34,197,574 shares of the registrant's common stock, par value $.001 per share.

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Part I

Item 1. Financial Statements

HEALTHWAYS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

ASSETS

	March 31, 2013	December 31, 2012
Current assets:		
Cash and cash equivalents	$ 2,384	$ 1,759
Accounts receivable, net	92,554	108,337
Prepaid expenses	8,915	9,727
Other current assets	9,237	7,227
Income taxes receivable	5,242	5,920
Deferred tax asset	9,026	8,839
Total current assets	127,358	141,809
Property and equipment:		
Leasehold improvements	41,089	40,679
Computer equipment and related software	272,007	267,902
Furniture and office equipment	24,221	23,552
Capital projects in process	15,153	11,799
	352,470	343,932
Less accumulated depreciation	(197,322)	(187,438)
	155,148	156,494
Other assets	21,092	21,042
Intangible assets, net	86,963	90,228
Goodwill, net	338,605	338,695
Total assets	$ 729,166	$ 748,268

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)
(Unaudited)

LIABILITIES AND STOCKHOLDERS' EQUITY

	March 31, 2013	December 31, 2012
Current liabilities:		
Accounts payable	$ 33,969	$ 26,343
Accrued salaries and benefits	18,249	24,909
Accrued liabilities	43,083	39,234
Deferred revenue	5,951	5,643
Contract billings in excess of earned revenue	16,846	14,793
Current portion of long-term debt	11,634	11,801
Current portion of long-term liabilities	3,413	5,535
Total current liabilities	133,145	128,258
Long-term debt	257,187	278,534
Long-term deferred tax liability	36,314	36,053
Other long-term liabilities	26,277	26,602
Stockholders' equity:		
Preferred stock		
$.001 par value, 5,000,000 shares authorized, none outstanding	—	—
Common stock		
$.001 par value, 120,000,000 shares authorized, 34,133,567 and 33,924,464 shares outstanding, respectively	34	34
Additional paid-in capital	252,530	251,357
Retained earnings	52,592	56,541
Treasury stock, at cost, 2,254,953 shares in treasury	(28,182)	(28,182)
Accumulated other comprehensive loss	(731)	(929)
Total stockholders' equity	276,243	278,821
Total liabilities and stockholders' equity	$ 729,166	$ 748,268

See accompanying notes to the consolidated financial statements.

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HEALTHWAYS, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(In thousands, except earnings per share data)
(Unaudited)

	Three Months Ended March 31,	
	2013	2012
Revenues	$ 165,165	$ 165,218
Cost of services (exclusive of depreciation and amortization of $8,825, and $8,683, respectively, included below)	141,257	140,235
Selling, general and administrative expenses	13,098	13,739
Depreciation and amortization	13,533	12,173
Operating loss	(2,723)	(929)
Interest expense	3,321	3,187
Loss before income taxes	(6,044)	(4,116)
Income tax benefit	(2,095)	(1,451)
Net loss	$ (3,949)	$ (2,665)
Loss per share:		
Basic	$ (0.12)	$ (0.08)
Diluted (1)	$ (0.12)	$ (0.08)
Comprehensive loss	$ (3,751)	$ (2,258)
Weighted average common shares and equivalents:		
Basic	34,018	33,346
Diluted (1)	34,018	33,346

(1) The assumed exercise of stock-based compensation awards for the three months ended March 31, 2013 and March 31, 2012 was not considered because the impact would be anti-dilutive.

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
For the Three Months Ended March 31, 2013
(In thousands)
(Unaudited)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2012	$—	$34	$251,357	$56,541	$(28,182)	$(929)	$278,821
Comprehensive income (loss)	—	—	—	(3,949)	—	198	(3,751)
Exercise of stock options	—	—	360	—	—	—	360
Tax effect of stock options and restricted stock units	—	—	(724)	—	—	—	(724)
Share-based employee compensation expense	—	—	1,537	—	—	—	1,537
Balance, March 31, 2013	$—	$34	$252,530	$52,592	$(28,182)	$(731)	$276,243

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2013	2012
Cash flows from operating activities:		
Net loss	$ (3,949)	$ (2,665)
Adjustments to reconcile net loss to net cash flows provided by (used in)		
operating activities, net of business acquisitions:		
Depreciation and amortization	13,533	12,173
Amortization and write-off of deferred loan costs	235	435
Share-based employee compensation expense	1,537	1,394
Deferred income taxes	50	(1,562)
Excess tax benefits from share-based payment arrangements	(137)	(3)
Decrease (increase) in accounts receivable, net	15,936	(10,226)
(Increase) decrease in other current assets	(128)	2,024
Increase (decrease) in accounts payable	77	(5,002)
Decrease in accrued salaries and benefits	(7,193)	(14,063)
Increase in other current liabilities	6,919	8,241
Other	(851)	(2,320)
Net cash flows provided by (used in) operating activities	26,029	(11,574)
Cash flows from investing activities:		
Acquisition of property and equipment	(11,264)	(15,085)
Other	(1,918)	(1,825)
Net cash flows used in investing activities	(13,182)	(16,910)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	105,200	115,575
Payments of long-term debt	(127,078)	(91,228)
Deferred loan costs	(744)	—
Excess tax benefits from share-based payment arrangements	137	3
Exercise of stock options	360	9
Change in outstanding checks and other	10,257	4,287
Net cash flows (used in) provided by financing activities	(11,868)	28,646
Effect of exchange rate changes on cash	(354)	120
Net increase in cash and cash equivalents	625	282
Cash and cash equivalents, beginning of period	1,759	864
Cash and cash equivalents, end of period	$ 2,384	$ 1,146

See accompanying notes to the consolidated financial statements.

HEALTHWAYS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

(1) Basis of Presentation

Our financial statements and accompanying notes are prepared in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"). In our opinion, the accompanying consolidated financial statements of Healthways, Inc. and its wholly-owned subsidiaries ("Healthways," the "Company," or such terms as "we," "us," or "our") reflect all adjustments consisting of normal, recurring accruals necessary for a fair presentation.

We have omitted certain financial information that is normally included in financial statements prepared in accordance with U.S. GAAP but that is not required for interim reporting purposes. You should read the accompanying consolidated financial statements in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012.

(2) Recent Accounting Standards

In July 2012, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2012-02, "Intangibles—Goodwill and Other (Topic 350)—Testing Indefinite-Lived Intangible Assets for Impairment." ASU No. 2012-02 permits an entity to perform a qualitative assessment to determine whether it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying value. If the entity concludes that this is the case, it must perform the currently prescribed quantitative impairment test by comparing the fair value of the indefinite-lived intangible asset with its carrying value. Otherwise, the quantitative impairment test is not required. ASU No. 2012-02 is effective for fiscal years beginning after September 15, 2012, with earlier adoption permitted. We adopted this standard for the fiscal year beginning January 1, 2013. The adoption of this standard did not have a material impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

In February 2013, the FASB issued ASU No. 2013-02, "Comprehensive Income (Topic 220)—Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income," which requires companies to provide information about the amounts reclassified out of accumulated other comprehensive income ("AOCI") by component. In addition, entities are required to present, either on the face of the statement where net income is presented or in the accompanying notes, significant amounts reclassified out of AOCI by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. For amounts that are not required to be reclassified in their entirety to net income, entities are required to cross-reference to other disclosures that provide additional detail on those amounts. ASU No. 2013-02 is effective prospectively for reporting periods beginning after December 15, 2012. We adopted this standard for the interim period beginning January 1, 2013. The adoption of this standard did not have a material impact on our consolidated results of operations, financial position, cash flows, or notes to the consolidated financial statements.

(3) Share-Based Compensation

We have several stockholder-approved stock incentive plans for our employees and directors. We currently have three types of share-based awards outstanding under these plans: stock options, restricted stock units, and restricted stock. We believe that such awards align the interests of our employees and directors with those of our stockholders.

For the three months ended March 31, 2013 and 2012, we recognized share-based compensation costs of $1.5 million and $1.4 million, respectively.

A summary of our stock options as of March 31, 2013 and changes during the three months then ended is presented below:

Options	Shares (000s)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value ($000s)
Outstanding at January 1, 2013	4,689	$ 15.65		
Granted	894	12.85		
Exercised	(95)	9.74		
Forfeited	(75)	9.63		
Expired	(31)	19.55		
Outstanding at March 31, 2013	5,382	15.35	6.06	$5,526
Exercisable at March 31, 2013	2,959	18.82	3.70	$1,459

The weighted-average grant-date fair value of options granted during the three months ended March 31, 2013 was $7.06.

The following table shows a summary of our restricted stock and restricted stock units ("nonvested shares") as of March 31, 2013, as well as activity during the three months then ended:

Nonvested Shares	Shares (000s)	Weighted-Average Grant Date Fair Value
Nonvested at January 1, 2013	1,013	$ 9.93
Granted	146	12.84
Vested	(167)	10.29
Forfeited	(41)	9.63
Nonvested at March 31, 2013	951	$ 10.33

(4) Income Taxes

Our effective tax benefit rate remained relatively consistent at approximately 35% for the three months ended March 31, 2013 compared to the three months ended March 31, 2012.

We file income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. Tax years remaining subject to examination in these jurisdictions include 2009 to present.

(5) Derivative Investments and Hedging Activities

We use derivative instruments to manage risks related to interest rates and foreign currencies. We record all derivatives at estimated fair value as either assets or liabilities on the consolidated balance sheets and recognize the unrealized gains and losses in either the consolidated balance sheets or statements of comprehensive loss, depending on whether the derivative is designated as a hedging instrument. As permitted under our master netting arrangements, the fair value amounts of our derivative instruments are presented on a net basis by counterparty in the consolidated balance sheets.

Interest Rate

In order to reduce our exposure to interest rate fluctuations on our floating rate debt commitments, we maintain interest rate swap agreements that effectively modify our exposure to interest rate risk by converting a portion of our floating rate debt to fixed obligations, thus reducing the impact of interest rate changes on future interest expense. Under these agreements, we receive a variable rate of interest based on LIBOR (as defined in Note 7), and we pay a fixed rate of interest with interest rates ranging from 0.370% to 3.385% plus a spread (see Note 7). We maintain interest rate swap agreements with current notional amounts of $415.0 million and termination dates ranging from June 30, 2013 to December 31, 2016. Of this amount, $195.0 million was effective at March 31, 2013, $110.0 million will become effective in June 2013, $60.0 million will become effective in November 2013, and $50.0 million will become effective in 2015, as older interest rate swap agreements expire. We have designated these interest rate swap agreements as qualifying cash flow hedges. We currently meet the hedge accounting criteria under U.S. GAAP in accounting for these interest rate swap agreements.

Foreign Currency

We enter into foreign currency options and/or forward contracts in order to minimize our earnings exposure to fluctuations in foreign currency exchange rates. Our foreign currency exchange contracts do not qualify for hedge accounting treatment under U.S. GAAP. We routinely monitor our foreign currency exposures to maximize the overall effectiveness of our foreign currency hedge positions. We do not execute transactions or hold derivative financial instruments for trading or other purposes.

Fair Values of Derivative Instruments

The estimated gross fair values of derivative instruments at March 31, 2013 and December 31, 2012, excluding the impact of netting derivative assets and liabilities when a legally enforceable master netting agreement exists, were as follows:

	March 31, 2013		December 31, 2012	
(In $000s)	Foreign currency exchange contracts	Interest rate swap agreements	Foreign currency exchange contracts	Interest rate swap agreements
Assets:				
Derivatives not designated as hedging instruments:				
Other current assets	$35	$—	$73	$—
Total assets	$35	$—	$73	$—
Liabilities:				
Derivatives not designated as hedging instruments:				
Accrued liabilities	$103	$—	$255	$—
Derivatives designated as hedging instruments:				
Accrued liabilities	—	1,128	—	1,742
Other long-term liabilities	—	1,263	—	1,221
Total liabilities	$103	$2,391	$255	$2,963

See also Note 6.

Cash Flow Hedges

Derivative instruments that are designated and qualify as cash flow hedges are recorded at estimated fair value in the consolidated balance sheets, with the effective portion of the gains and losses being reported in accumulated other comprehensive income or loss ("accumulated OCI"). Cash flow hedges for all periods presented consist solely of interest rate swap agreements. Gains and losses on these interest rate swap agreements are reclassified to interest expense in the same period during which the hedged transaction affects earnings or the period in which all or a portion of the hedge becomes ineffective. As of March 31, 2013, we expect to reclassify $1.6 million of net losses on interest rate swap agreements from accumulated OCI to interest expense within the next 12 months due to the scheduled payment of interest associated with our debt.

The following table shows the effect of our cash flow hedges on the consolidated balance sheets during the three months ended March 31, 2013 and March 31, 2012:

(In $000s)	For the Three Months Ended	
Derivatives in Cash Flow Hedging Relationships	March 31, 2013	March 31, 2012
Loss related to effective portion of derivatives recognized in accumulated OCI, gross of tax effect	$58	$371
Loss related to effective portion of derivatives reclassified from accumulated OCI to interest expense, gross of tax effect	$629	$929

Gains and losses representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. During the three months ended March 31, 2013 and 2012, there were no gains or losses on cash flow hedges recognized in our consolidated statements of comprehensive income resulting from hedge ineffectiveness.

Derivative Instruments Not Designated as Hedging Instruments

Our foreign currency exchange contracts require current period mark-to-market accounting, with any change in fair value being recorded each period in the consolidated statements of comprehensive income in selling, general and administrative expenses. At March 31, 2013, we had forward contracts with notional amounts of $6.6 million to exchange foreign currencies, primarily the Australian dollar and Euro, that were entered into in order to hedge forecasted foreign net income (loss) and intercompany debt. These forward contracts did not have a material effect on our consolidated statements of comprehensive income during the three months ended March 31, 2013 and 2012.

(6) Fair Value Measurements

We account for certain assets and liabilities at fair value. Fair value is defined as the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date, assuming the transaction occurs in the principal or most advantageous market for that asset or liability.

Fair Value Hierarchy

The hierarchy below lists three levels of fair value based on the extent to which inputs used in measuring fair value are observable in the market. We categorize each of our fair value measurements in one of these three levels based on the lowest level input that is significant to the fair value measurement in its entirety. These levels are:

Level 1: Quoted prices in active markets for identical assets or liabilities;

Level 2: Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-based valuation techniques in which all significant assumptions are observable in the market or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3: Unobservable inputs that are supported by little or no market activity and typically reflect management's estimates of assumptions that market participants would use in pricing the asset or liability.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present our assets and liabilities measured at fair value on a recurring basis at March 31, 2013 and December 31, 2012:

(In $000s) March 31, 2013	Level 2	Gross Fair Value	Netting (1)	Net Fair Value
Assets:				
Foreign currency exchange contracts	$ 35	$ 35	$ (30)	$ 5
Liabilities:				
Foreign currency exchange contracts	$ 103	$ 103	$ (30)	$ 73
Interest rate swap agreements	2,391	2,391	—	2,391

(In $000s) December 31, 2012	Level 2	Gross Fair Value	Netting (1)	Net Fair Value
Assets:				
Foreign currency exchange contracts	$ 73	$ 73	$ (73)	$ —
Liabilities:				
Foreign currency exchange contracts	$ 255	$ 255	$ (73)	$ 182
Interest rate swap agreements	2,963	2,963	—	2,963

(1) This column reflects the impact of netting derivative assets and liabilities by counterparty when a legally enforceable master netting agreement exists.

The fair values of forward foreign currency exchange contracts are valued using broker quotations of similar assets or liabilities in active markets. The fair values of interest rate swap agreements are primarily determined based on the present value of future cash flows using internal models and third-party pricing services with observable inputs, including interest rates, yield curves and applicable credit spreads.

Fair Value of Other Financial Instruments

In addition to foreign currency exchange contracts and interest rate swap agreements, the estimated fair values of which are disclosed above, the estimated fair value of each class of financial instruments at March 31, 2013 was as

follows:

- Cash and cash equivalents – The carrying amount of $2.4 million approximates fair value because of the short maturity of those instruments (less than three months).

- Long-term debt – The estimated fair value of outstanding borrowings under the Fifth Amended and Restated Revolving Credit and Term Loan Agreement (as amended, the "Fifth Amended Credit Agreement"), which includes a revolving credit facility and a term loan facility (see Note 7), is determined based on the fair value hierarchy as discussed above. The revolving credit facility and the term loan facility are not actively traded and therefore are classified as Level 2 valuations based on the market for similar instruments. The estimated fair value is based on the average of the prices set by the issuing bank given current market conditions and is not necessarily indicative of the amount we could realize in a current market exchange. The estimated fair value and carrying amount of outstanding borrowings under the Fifth Amended Credit Agreement at March 31, 2013 are $265.7 million and $266.4 million, respectively.

(7) Long-Term Debt

On June 8, 2012, we entered into the Fifth Amended Credit Agreement. The Fifth Amended Credit Agreement provides us with a $200.0 million revolving credit facility that expires on June 8, 2017 and includes a swingline sub facility of $20.0 million and a $75.0 million sub facility for letters of credit. The Fifth Amended Credit Agreement also provides a $200.0 million term loan facility that matures on June 8, 2017, $192.5 million of which remained outstanding on March 31, 2013, and an uncommitted incremental accordion facility of $200.0 million. As of March 31, 2013, availability under the revolving credit facility totaled $82.6 million as calculated under the most restrictive covenant.

Borrowings under the Fifth Amended Credit Agreement generally bear interest at variable rates based on a margin or spread in excess of either (1) the one-month, two-month, three-month or six-month rate (or with the approval of affected lenders, nine-month or twelve-month rate) for Eurodollar deposits ("LIBOR") or (2) the greatest of (a) the SunTrust Bank prime lending rate, (b) the federal funds rate plus 0.50%, and (c) one-month LIBOR plus 1.00% (the "Base Rate"), as selected by the Company. The LIBOR margin varies between 1.75% and 3.00%, and the Base Rate margin varies between 0.75% and 2.00%, depending on our leverage ratio. The Fifth Amended Credit Agreement also provides for an annual fee ranging between 0.30% and 0.50% of the unused commitments under the revolving credit facility. Extensions of credit under the Fifth Amended Credit Agreement are secured by guarantees from all of the Company's active domestic subsidiaries and by security interests in substantially all of the Company's and such subsidiaries' assets.

On February 5, 2013, we entered into a First Amendment to the Fifth Amended Credit Agreement, which included, among other things, a temporary increase in the LIBOR and Base Rate margins of 0.25%. The increased margins are effective through December 31, 2013 and apply only in the event that our total funded debt to EBITDA ratio is greater than or equal to 3.50 to 1.00.

We are required to repay outstanding revolving loans under the revolving credit facility in full on June 8, 2017. We are required to repay term loans in quarterly principal installments aggregating (1) 1.250% of the original aggregate principal amount of the term loans during each of the eight quarters beginning with the quarter ended September 30, 2012, (2) 1.875% of the original aggregate principal amount of the term loans during each of the next four quarters beginning with the quarter ending September 30, 2014, and (3) 2.500% of the original aggregate principal amount of the term loans during each of the remaining quarters prior to maturity on June 8, 2017, at which time the entire unpaid principal balance of the term loans is due and payable.

The Fifth Amended Credit Agreement contains financial covenants that require us to maintain specified ratios or levels of (1) total funded debt to EBITDA and (2) fixed charge coverage. As of March 31, 2013, we were in compliance with all of the financial covenant requirements of the Fifth Amended Credit Agre