HEARUSA INC
Form 10-Q
November 09, 2004

UNITED STATES
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 September 25, 2004

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 001-11655

HearUSA, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**22-2748248**
(State of Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
1250 Northpoint Parkway, West Palm Beach, Florida	**33407**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s Telephone Number, Including Area Code (561) 478-8770

Former Name, Former Address and Former Fiscal Year,
if Changed Since Last Report

Indicate by check ü 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 ü whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o **No** þ

On October 29, 2004 29,516,483 shares of the Registrant s Common Stock and 913,419 exchangeable shares of HEARx Canada, Inc. were outstanding.

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Part I Financial Information

Item 1. Financial Statements

HearUSA, Inc.
Consolidated Balance Sheets

	September 25, 2004	December 27, 2003
	(unaudited)	(audited)
ASSETS		
Current assets		
Cash and cash equivalents	$ 2,498,247	$ 6,714,881
Restricted Cash	285,000	
Investment securities	150,000	435,000
Accounts and notes receivable, less allowance for doubtful accounts of $386,544 and $490,881	6,791,231	6,539,149
Inventories	925,755	979,092
Prepaid expenses and other	611,982	1,115,393
Total current assets	**11,262,215**	**15,783,515**
Property and equipment, net	**3,923,851**	**4,969,265**
Goodwill	**33,410,903**	**33,222,779**
Intangible assets, net	**11,276,580**	**11,577,097**
Deposits and other	**375,733**	**630,694**
	$ 60,249,282	**$ 66,183,350**
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Accounts payable	$ 7,160,003	$ 6,750,234
Accrued expenses	2,062,064	2,492,094
Accrued salaries and other compensation	1,972,280	1,706,252
Current maturities of long-term debt	4,105,704	6,436,271
Dividends payable	253,970	728,699
Total current liabilities	**15,554,021**	**18,113,550**
Long-term debt	**18,318,802**	**20,579,977**
Commitments and contingencies		
Convertible subordinated notes, net of debt discount of $5,938,723 and $7,423,596 (Note 4)	**1,561,277**	**76,404**
Mandatorily redeemable convertible preferred stock	**4,682,468**	**4,600,107**

(Series E)		
Stockholders equity		
Preferred stock (Aggregate liquidation preference $2,330,000; $1 par, 7,500,000 shares authorized)		
Series H Junior Participating (none outstanding)		
Series J (233 shares outstanding)	233	233
Total preferred stock	233	233
Common stock: $.10 par; 75,000,000 shares authorized 30,040,010 and 29,528,432 shares issued	3,004,014	2,952,845
Stock subscription	(412,500)	(412,500)
Additional paid-in capital	120,091,819	120,226,050
Accumulated deficit	(101,283,036)	(98,501,791)
Accumulated other comprehensive income	1,217,325	1,033,616
Treasury stock, at cost: 523,662 and 523,662 common shares	(2,485,141)	(2,485,141)
Total stockholders equity	**20,132,714**	**22,813,312**
	$ 60,249,282	**$ 66,183,350**

See accompanying notes to the consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Operations
Nine Months Ended September 25, 2004 and September 27, 2003

	September 25, 2004	September 27, 2003
	(unaudited)	(unaudited)
Net revenues	$53,515,329	$53,664,664
Operating costs and expenses		
Cost of products sold	15,064,687	15,202,201
Center operating expenses	27,971,230	26,062,405
General and administrative expenses	7,534,233	7,529,998
Depreciation and amortization	1,755,384	2,334,585
Total operating costs and expenses	52,325,534	51,129,189
Income from operations	1,189,795	2,535,475
Non-operating income (expense):		
Interest income	11,045	16,701
Interest expense (including approximately $1,595,000 of non-cash debt discount amortization in 2004)	(3,467,304)	(1,608,717)
Income (loss) from continuing operations	(2,266,464)	943,459
Discontinued operations		
Loss from discontinued operations		(201,536)
Net income (loss) before dividends on preferred stock	(2,266,464)	741,923
Dividends on preferred stock	(530,828)	(439,972)
Net income (loss) applicable to common stockholders	$ (2,797,292)	$ 301,951
Net income (loss) from continuing operations, including dividends on preferred stock, per common share - basic	$ (0.09)	$ 0.02
Net income (loss) from continuing operations, including dividends on preferred stock, per common share - diluted	$ (0.09)	$ 0.01
	$ (0.09)	$ 0.01

Net income (loss) applicable to common stockholders per common share - basic		
Net income (loss) applicable to common stockholders per common share - diluted	$ (0.09)	$ 0.01
Weighted average number of shares of common stock outstanding - basic	30,425,804	30,424,466
Weighted average number of shares of common stock outstanding - diluted	30,425,804	48,191,168

See accompanying notes to the consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Operations
Three Months Ended September 25, 2004 and September 27, 2003

	September 25, 2004	September 27, 2003
	(unaudited)	(unaudited)
Net revenues	$18,430,846	$17,276,558
Operating costs and expenses		
Cost of products sold	5,084,418	4,745,705
Center operating expenses	9,118,614	8,927,598
General and administrative expenses	2,585,408	2,657,870
Depreciation and amortization	563,816	700,011
Total operating costs and expenses	17,352,256	17,031,184
Income from operations	1,078,590	245,374
Non-operating income (expense):		
Interest income	3,601	4,740
Interest expense (including approximately $532,000 of non-cash debt discount amortization in 2004)	(1,138,273)	(493,179)
Loss from continuing operations	(56,082)	(243,065)
Discontinued operations		
Loss from discontinued operations		(3,830)
Net loss before dividends on preferred stock	(56,082)	(246,895)
Dividends on preferred stock	(177,331)	(142,547)
Net loss applicable to common stockholders	$ (233,413)	$ (389,442)
Net loss from continuing operations, including dividends on preferred stock, per common share - basic	$ (0.01)	$ (0.01)
Net loss from continuing operations, including dividends on preferred stock, per common share - diluted	$ (0.01)	$ (0.01)
	$ (0.01)	$ (0.01)

Net loss applicable to common stockholders per common share - basic		
Net loss applicable to common stockholders per common share - diluted	$ (0.01)	$ (0.01)
Weighted average number of shares of common stock outstanding - basic	30,429,902	30,423,652
Weighted average number of shares of common stock outstanding - diluted	30,429,902	30,423,652

See accompanying notes to the consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Cash Flows
Nine Months Ended September 25, 2004 and September 27, 2003

	September 25, 2004	September 27, 2003
	(unaudited)	(unaudited)
Cash flows from operating activities		
Net income (loss)	$(2,266,464)	$ 741,923
Loss from discontinued operations		201,536
Net income (loss) from continuing operations	(2,266,464)	943,459
Adjustments to reconcile net (loss) gain to net cash (used in) provided by operating activities:		
Depreciation and amortization	1,755,384	2,335,085
Provision for doubtful accounts	313,443	591,663
Debt discount amortization	1,595,300	
Principal payments on long-term debt made through preferred pricing reductions	(2,190,603)	(2,189,836)
Interest on Siemens Tranche D	480,215	576,643
Executive compensation expense	19,750	
Equipment purchases through vendor credit	(158,800)	
Consulting expense through issuance of warrants	6,881	
Cash flows provided by (used in) operations before changes in non-cash current assets and liabilities	(444,894)	2,257,014
(Increase) decrease in:		
Accounts and notes receivable	(1,202,220)	(1,261,040)
Inventories	54,764	(135,218)
Prepaid expenses and other	759,068	526,216
Increase (decrease) in:		
Accounts payable and accrued expenses	(146,817)	(1,122,961)
Accrued salaries and other compensation	248,304	(1,699,867)
Net cash used in continuing operations	(731,795)	(1,435,856)
Net cash used in discontinued operations		(372,098)
Net cash used in operations	(731,795)	(1,807,954)
Cash flows from investing activities		
Purchase of property and equipment	(176,656)	(213,516)
Capital expenditures of discontinued operations		(8,196)

Proceeds from sales of discontinued operations	102,539	1,164,667
Net cash (used in) provided by investing activities	(74,117)	942,955
Cash flows from financing activities		
Proceeds from issuance of long-term debt	500,000	3,500,000
Payments on long-term debt from discontinued operations		(29,822)
Principal payments on long-term debt	(2,894,616)	(962,210)
Purchase of treasury stock		(1,700)
Cost of exchange & redemption of capital stock	(102,382)	(153,757)
Proceeds from Board of Director sale of stock		40,250
Proceeds from exercise of employee stock options	4,189	15
Dividends on preferred stock	(923,196)	(339,800)
Net cash provided by (used in) financing activities	(3,416,005)	2,052,976
Effects of exchange rate changes on cash	5,283	17,305
Net increase (decrease) in cash and cash equivalents	**(4,216,634)**	**1,205,282**
Cash and cash equivalents at beginning of period	**6,714,881**	**2,410,023**
Cash and cash equivalents at end of period	**$ 2,498,247**	**$ 3,615,305**

See accompanying notes to consolidated financial statements

HearUSA, Inc.
Consolidated Statements of Cash Flows
Nine Months Ended September 25, 2004 and September 27, 2003

	September 25, 2004	September 27, 2004
	(unaudited)	(unaudited)
Supplemental disclosure of cash flows information:		
Cash paid for interest	$934,777	$309,112
Supplemental schedule of non-cash investing and financing activities:		
Capital lease of property and equipment		409,910

See accompanying notes to consolidated financial statements

HearUSA, Inc.
Notes to Consolidated Financial Statements

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles 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. Operating results for the nine month period ended September 25, 2004 are not necessarily indicative of the results that may be expected for the year ending December 25, 2004. For further information, refer to the audited consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 27, 2003.

1. Description of the Company and Summary of Significant Accounting Policies

The Company

HearUSA, Inc. (HearUSA or the Company), a Delaware corporation, was organized for the purpose of creating a nationwide chain of centers to serve the needs of the hearing impaired. The Company now has a network of 156 company-owned hearing care centers in 11 states and the Province of Ontario, Canada. The Company also sponsors a network of approximately 1,400 credentialed audiology providers that participate in selected hearing benefit programs contracted by the company with employer groups, health insurers and benefit sponsors in 49 states. The centers and the network providers provide audiological products and services for the hearing impaired.

Basis of consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned and majority controlled subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

Income (loss) per common share

Net income (loss) per common share is calculated in accordance with Statement of Financial Accounting Standards (SFAS) No. 128 Earnings Per Share which requires companies to present basic and diluted earnings per share. Net income (loss) per common share basic is based on the weighted average number of common shares outstanding during the year. Net income (loss) per common share diluted is based on the weighted average number of common shares and dilutive potential common shares outstanding during the year. Convertible subordinated notes, mandatorily redeemable convertible preferred stock, convertible preferred stock, stock options and stock warrants are excluded from the computations of net loss per common share because the effect of their inclusion would be anti-dilutive.

Due to the Company s net loss for the first nine months of 2004, the following common stock equivalents for convertible subordinated notes, mandatorily redeemable convertible preferred stock, outstanding options and warrants to purchase common stock of 9,505,864 were excluded from the computation of net loss per common share diluted at September 25, 2004 because they were anti-dilutive. For computing net income per share-diluted for the nine months ended September 27, 2003, 16,997,723 shares were included which represents the common stock equivalent for the outstanding convertible preferred stock of the Company. For purposes of computing net income (loss) per common share basic and diluted, for the nine and three months ended September 25, 2004 and September 27, 2003, the weighted average number of shares of common stock outstanding includes the effect of the 913,419 and 2,055,943, respectively, exchangeable shares of HEARx Canada, Inc., as if they were outstanding common stock of the Company on June 30, 2002, the effective date of the combination with Helix for financial reporting purposes.

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HearUSA, Inc.
Notes to Consolidated Financial Statements

Comprehensive income

Comprehensive income is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. The Company s other comprehensive income represents a foreign currency translation adjustment.

Comprehensive income (loss) and the components of other comprehensive income are as follows:

	Nine Months Ended		Three Months Ended	
	September 25, 2004	**September 27, 2003**	**September 25, 2004**	**September 27, 2003**
Net income (loss) for the period	$(2,266,464)	$ 741,923	$ (56,082)	$ (246,895)
Other comprehensive income:				
Foreign currency translation adjustments	183,709	(249,737)	486,339	(248,465)
Comprehensive income (loss) for the period	$(2,082,755)	$ 492,186	$ 430,257	$ (495,360)

Stock-based compensation

The Company has granted stock options to employees and directors under stock option plans. The Company accounts for those plans using the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees . Stock-based employee compensation cost reflected in net income (loss) is not significant, as all options granted under those plans had an exercise price greater than or equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income (loss) and income (loss) per share if the Company had applied the fair value recognition provisions of SFAS No. 123, (SFAS 123) Accounting for Stock-Based Compensation , to stock-based employee compensation:

	Nine Months Ended		Three Months Ended	
	September 25, 2004	**September 27, 2003**	**September 25, 2004**	**September 27, 2003**
Net income (loss) applicable to common stockholders as reported	$(2,797,292)	$ 301,951	$ (233,413)	$ (389,442)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(536,000)	(312,000)	(350,000)	(134,000)

Pro forma	$(3,333,292)	$ (10,049)	$ (583,413)	$ (523,442)
Income (loss) per share-basic				
As reported	$ (0.09)	$ 0.01	$ (0.01)	$ (0.01)
Pro forma	$ (0.11)	$ 0.00	$ (0.02)	$ (0.02)
Income (loss) per share diluted				
As reported	$ (0.09)	$ 0.01	$ (0.01)	$ (0.01)
Pro forma	$ (0.11)	$ 0.00	$ (0.02)	$ (0.02)

For purposes of the above disclosure, the determination of the fair value of stock options granted in 2004 and 2003 was based on the following: (i) a risk free interest rate of 3.46%, and 2.15% respectively; (ii) expected option lives ranging from 5 to 10 years; (iii) expected volatility in the market price of the Company s common stock of 97% and 93%, respectively; and (iv) no dividends on the underlying common stock.

HearUSA, Inc.
Notes to Consolidated Financial Statements

Reclassifications

Certain amounts in the 2003 consolidated financial statements have been reclassified in order to conform to the 2004 presentation.

2. Cash and Cash Equivalents

Restricted Cash

During the nine months ended September 25, 2004 a certificate of deposit for $285,000 matured. The bank currently requires that the Company maintain this balance in its operating account.

3. Stockholders Equity

Common stock

During the nine months ended September 25, 2004, 2,425,000 employee stock options were issued at exercise prices ranging from $1.33 to $2.31, no warrants were exercised and employee stock options for 6,250 shares of common stock were exercised.

4. Convertible Subordinated Notes

On December 19, 2003, the Company completed a private placement of $7.5 million five-year convertible subordinated notes with five-year warrants to purchase 2,642,750 shares of the Company s common stock. The notes may not be converted and warrants to purchase 2,142,750 shares may not be exercised for a two-year period. The remaining warrants to purchase 500,000 shares are exercisable beginning in June 2005 at $1.75 per share. Beginning in December 2005 the notes may be converted at $1.75 per share and the warrants may be exercised for up to 2,142,750 shares at $1.75 per share. The quoted closing market price of the Company s common stock on the commitment date was $2.37 per share. The notes bear interest at 11 percent per annum for the first two years and then at 8 percent per annum through the remainder of their term.

Proceeds from this financing were used to repay the $2 million notes that were issued on October 3, 2003. In addition, approximately $1.8 million of the net proceeds were used to make payments to Siemens in early fiscal 2004 under the Credit Agreement, including 50% against the Tranche D Loan and 50% against the Tranche E Loan. The balance of the net proceeds was used for working capital. As of December 27, 2003, $500,000 of the financing proceeds was recorded as a subscription receivable under the caption accounts and notes receivable in the accompanying consolidated balance sheet, and was received in January 2004.

Beginning March 25, 2004, the Company is required to make quarterly payments of interest only. Beginning March 25, 2006, the Company is required to make twelve equal quarterly payments of principal plus interest. Payments of interest and principal may be made, at the Company s option, in cash or with the Company s common stock. If payments are made using the Company s common stock the shares to be issued would be computed at 90% of the average closing price for the 20 day trading period immediately preceding the payment date. Approximate aggregate amount of maturities of the convertible subordinated notes maturing in future years as of September 25, 2004, is $2,500,000 in each of 2006, 2007 and 2008.

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HearUSA, Inc.
Notes to Consolidated Financial Statements

In addition to the 2,642,750 common stock purchase warrants issued to the investors in the $7.5 million financing, the Company also issued 117,143 common stock purchase warrants with the same terms as the lender warrants and paid cash of approximately $206,000 to third parties as finder fees and financing costs. These warrants were valued at approximately $220,000 using a Black-Scholes option pricing model. The total of such costs of approximately $426,000 are being amortized as interest expense using the effective interest method over the five year term of the notes.

The Company recorded a debt discount of approximately $7,488,000 consisting of the intrinsic value of the beneficial conversion of approximately $4,519,000 and the portion of the proceeds allocated to the warrants issued to the lenders of approximately $2,969,000, using the Black-Scholes option pricing model, based on the relative fair values of the warrants and the notes. The debt discount is being amortized as interest expense over the five-year term of the notes using the interest method.

During the first nine months of 2004, approximately $2,170,000 of prepaid financing fees and debt discount was amortized as interest expense, including a non-cash portion of approximately $1,595,000. The future non-cash debt discount and prepaid finder fees to be amortized as interest expense over the next five years are approximately $532,000 for the remainder of 2004, $2,151,000 in 2005, $1,763,000 in 2006, $1,145,000 in 2007 and $434,000 in 2008. In the event the investors convert or exercise the debt or warrants, the Company will be required to amortize the remaining debt discount in the period in which the exercise or conversion occurs.

5. Discontinued Operations

On July 15, 2003, the Company sold 100% of the shares of the Company s three subsidiaries and selected assets associated with the management of the centers located in the Canadian Province of Quebec, to Forget & Sauve, Audioprothesistes, S.E.N.C. (Forget & Sauve) and 6068065 Canada Inc., private entities owned and controlled by Steve Forget, a former Helix officer and director. Mr. Forget served as an officer of the Company until October 2002 and as a director until May 2003. The sale agreement provided for total payments to the Company of approximately $1.7 million, which included in part payment of pre-existing debt, owed the Company by Forget & Sauve of approximately $1.6 million. The Company received an initial cash payment of $700,000 at closing and $1 million over the five following months, including an amount of approximately $103,000 received in January 2004.

The three Quebec subsidiaries and selected assets have been presented as a discontinued operation and the consolidated financial statements have been reclassified to segregate the assets, liabilities and operating results of these subsidiaries for all periods presented. The sale resulted in a loss on disposal of approximately $105,000 recorded in the second quarter of 2003. Net revenues of the discontinued operations for the nine and three months ended September 27, 2003 were approximately $2,559,000 and $1,391,000 respectively and net loss of the discontinued operations was approximately $93,000 and $136,000 respectively.

HearUSA, Inc.
Notes to Consolidated Financial Statements

6. Segments

The Company operates in three business segments, which include the operation and management of centers, the establishment, maintenance and support of an affiliated network and the operation of an e-commerce business. The Company s business units are located in the United States and Canada.

	Centers	E-commerce	Network	Corporate	Total
Net revenues					
9 months ended 9/25/04	$52,686,000	$ 46,000	$ 783,000		$53,515,000
9 months ended 9/27/03	52,826,000	53,000	786,000		53,665,000
Income (loss) from operations					
9 months ended 9/25/04	8,635,000	(12,000)	312,000	(7,745,000)	1,190,000
9 months ended 9/27/03	10,693,000	(38,000)	390,000	(8,509,000)	2,536,000
9 months ended 9/25/04					
Depreciation and amortization	1,540,000		4,000	211,000	1,755,000
Identifiable assets	47,324,000		1,481,000	11,444,000	60,249,000
Capital expenditures	149,000		2,000	26,000	177,000
9 months ended 9/27/03					
Depreciation and amortization	1,623,000		3,000	709,000	2,335,000
Identifiable assets	43,977,000		1,702,000	16,788,000	62,467,000
Capital expenditures	134,000			79,000	213,000

Income from operations at the segment level are computed before general and administrative expenses.

Information concerning geographic areas as of and for the nine months ended September 25, 2004 and September 27, 2003 are as follows:

	United States 2004	Canada 2004	United States 2003	Canada 2003
Net revenues	$ 48,579,000	$ 4,936,000	$	$