VSE CORP
Form 10-Q
May 01, 2012

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United States
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

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

For the Quarter Ended March 31, 2012
Commission file number 0-3676

VSE CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	54-0649263
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2550 Huntington Avenue, Alexandria, VA 22303-1499 (703/960-4600)
(Address and telephone number of principal executive offices)

www.vsecorp.com
(webpage)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of each exchange on which registered
Common Stock, $0.05 par value	The NASDAQ Global Select Market

Securities registered pursuant to Section 12(g) of the Act: None

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, 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(section 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, or a non-accelerated filer. See definition of “accelerated filer” and “large accelerated filer” in Rule 12b-2 of the Exchange Act (check one).
Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12-b2 of the Exchange Act). Yes ¨ No x

Number of shares of Common Stock outstanding as of April 20, 2012: 5,286,706.

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VSE Corporation and Subsidiaries

Forward Looking Statements

This report contains statements that, to the extent they are not recitations of historical fact, constitute "forward looking statements" under federal securities laws. All such statements are intended to be subject to the safe harbor protection provided by applicable securities laws. For discussions identifying some important factors that could cause actual VSE Corporation ("VSE," the "Company," "us," "our," or "we") results to differ materially from those anticipated in the forward looking statements contained in this report, see VSE's discussions captioned "Business," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Notes to Consolidated Financial Statements" contained in VSE's Annual Report on Form 10-K for the fiscal year ended December 31, 2011 filed with the Securities and Exchange Commission (the "SEC") on March 7, 2012.

Readers are cautioned not to place undue reliance on these forward looking statements, which reflect management's analysis only as of the date hereof. We undertake no obligation to revise publicly these forward looking statements to reflect events or circumstances that arise after the date hereof. Readers should carefully review the risk factors described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and in the reports and other documents the Company files from time to time with the SEC, including this and other Quarterly Reports on Form 10-Q to be filed by us subsequent to our Annual Report on Form 10-K and any Current Reports on Form 8-K we file.

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PART I. Financial Information

Item 1. Financial Statements

VSE Corporation and Subsidiaries

Unaudited Condensed Consolidated Balance Sheets
(in thousands except share and per share amounts)

	March 31, 2012	December 31, 2011
Assets		
Current assets:		
Cash and cash equivalents	$368	$451
Receivables, principally U.S. Government, net	112,850	117,568
Inventories	42,454	41,990
Deferred tax assets	385	1,355
Other current assets	17,233	17,083
Total current assets	173,290	178,447
Property and equipment, net	64,107	57,113
Intangible assets, net	103,734	106,536
Goodwill	98,879	98,879
Deferred tax assets	-	231
Other assets	15,776	13,306
Total assets	$455,786	$454,512
Liabilities and Stockholders' Equity		
Current liabilities:		
Current portion of long-term debt	$18,587	$18,587
Accounts payable	38,729	50,353
Current portion of earn-out obligations	8,660	4,153
Accrued expenses and other current liabilities	29,402	33,864
Dividends payable	370	367
Total current liabilities	95,748	107,324
Long-term debt, less current portion	151,970	144,759
Deferred compensation	10,515	8,215
Long-term lease obligations, less current portion	34,136	33,938
Deferred income taxes	1,010	-
Earn-out obligations, less current portion	11,356	16,415
Other liabilities	376	261
Total liabilities	305,111	310,912
Commitments and contingencies		

Stockholders’ equity:		
Common stock, par value $0.05 per share, authorized 15,000,000 shares; issued and outstanding 5,286,706 and 5,246,527, respectively	264	262
Additional paid-in capital	18,040	17,069
Retained earnings	133,258	126,961
Accumulated other comprehensive loss	(887)	(692)
Total stockholders’ equity	150,675	143,600
Total liabilities and stockholders’ equity	$455,786	$454,512

The accompanying notes are an integral part of these financial statements.

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VSE Corporation and Subsidiaries

Unaudited Condensed Consolidated Statements of Income
(in thousands except share and per share amounts)

	For the three months ended March 31, 2012	2011
Revenues:		
Services	$105,978	$148,247
Products	38,363	2,997
Total revenues	144,341	151,244
Contract costs:		
Services	100,301	141,426
Products	31,142	2,088
Total contract costs	131,443	143,514
Selling, general and administrative expenses	555	821
Operating income	12,343	6,909
Interest expense, net	1,532	144
Income before income taxes	10,811	6,765
Provision for income taxes	4,143	2,593
Net income	$6,668	$4,172
Basic weighted average shares outstanding	5,267,098	5,214,334
Basic earnings per share	$1.27	$0.80
Diluted weighted average shares outstanding	5,292,532	5,241,863
Diluted earnings per share	$1.26	$0.80
Dividends declared per share	$0.07	$0.06

The accompanying notes are an integral part of these financial statements.

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VSE Corporation and Subsidiaries

Unaudited Condensed Consolidated Statements of Comprehensive Income
(in thousands)

	For the three months ended March 31, 2012	2011
Net income	$6,668	$4,172
Change in fair value of interest rate swap agreements	(195)	-
Comprehensive income	$6,473	$4,172

The accompanying notes are an integral part of these financial statements.

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VSE Corporation and Subsidiaries

Unaudited Condensed Consolidated Statements of Cash Flows
(in thousands)

	For the three months ended March 31, 2012	2011
Cash flows from operating activities:		
Net income	$6,668	$4,172
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,850	2,382
Deferred taxes	2,331	1,079
Stock-based compensation	185	164
Earn-out obligation adjustment	(552)	-
Changes in operating assets and liabilities, net of impact of acquisitions:		
Receivables, net	4,718	19,007
Inventories	(464)	-
Other current assets and noncurrent assets	(2,708)	(4,456)
Accounts payable and deferred compensation	(9,324)	(13,267)
Accrued expenses and other current liabilities	976	(6,966)
Long-term lease obligations	(102)	10
Other liabilities	115	(2,432)
Net cash provided by (used in) operating activities	6,693	(307)
Cash flows from investing activities:		
Purchases of property and equipment	(8,620)	(904)
Cash paid for acquisitions, net of cash acquired	(4,607)	-
Earn-out obligation payments	(314)	(270)
Net cash used in investing activities	(13,541)	(1,174)
Cash flows from financing activities:		
Borrowings on loan arrangement	59,616	78,661
Repayments on loan arrangement	(52,446)	(80,328)
Payments on capital lease obligations	(37)	-
Dividends paid	(368)	(313)
Net cash provided by (used in) financing activities	6,765	(1,980)
Net decrease in cash and cash equivalents	(83)	(3,461)
Cash and cash equivalents at beginning of period	451	5,764
Cash and cash equivalents at end of period	$368	$2,303

The accompanying notes are an integral part of these financial statements.

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VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2012

(1) Nature of Business and Basis of Presentation

Our business is focused on providing sustainment services for U.S. Department of Defense ("DoD") legacy systems and equipment and professional services to DoD and Federal Civilian agencies, including the United States Postal Service (“USPS”). Our operations consist primarily of logistics, engineering, equipment refurbishment, supply chain management, IT solutions, health care IT, construction management and consulting services performed on a contract basis. Substantially all of our contracts are with United States Government (“government”) agencies and other government prime contractors.

Our accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and 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 accounting principles generally accepted in the United States for complete financial statements. In our opinion, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2012 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2012. For further information refer to the consolidated financial statements and footnotes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the financial statements include accruals for contract disallowance reserves, self-insured health claims and earn-out obligations related to acquisitions consummated after January 1, 2009.

As a result of our acquisition of Wheeler Bros., Inc (“WBI”), we are separately presenting revenue and contract costs for products and services. Revenue and contract costs amounts from the prior year have been reclassified to conform to the current year presentation.

(2) Debt

We have a loan agreement with a group of banks that was entered into in June 2011 to fund our acquisition of WBI and provide working capital for our continuing operations. The loan agreement, which expires in June 2016, consists of a term loan facility and a revolving loan facility that also provides us with letters of credit. Financing costs associated with the loan inception of approximately $1.7 million were capitalized and are being amortized over the five-year life of the loan. The loan agreement replaced a predecessor loan agreement that also consisted of a term loan, revolving loan, and letters of credit. The fair value of our outstanding debt as of March 31, 2012 approximates its carrying value.

The term loan requires quarterly installments payable, with 15% of the original $125 million principal amount due in each of the first two years, 20% due in each of years three and four, and 30% due in year five. The amount of term loan borrowings outstanding as of March 31, 2012 is approximately $106.3 million. The amount of term loan borrowings outstanding as of December 31, 2011 was approximately $110.9 million.

Our scheduled term loan payments following March 31, 2012 are: $14.1 million in 2012, $23.4 million in 2013, $25 million in 2014, $34.3 million in 2015, and $9.4 million in 2016.

The maximum amount of credit available to us from the banking group for revolving loans and letters of credit as of March 31, 2012 was $125 million. The loan agreement provides that we may elect to increase this maximum to $175 million. Under the loan agreement terms, we may borrow revolving loan amounts at any time and can repay the borrowings at any time without premium or penalty. We pay an unused commitment fee and fees on letters of credit that are issued. We had approximately $65.2 million in revolving loan borrowings outstanding and $5 million of letters

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2012

of credit outstanding as of March 31, 2012. We had approximately $53.3 million in revolving loan borrowings outstanding and $5 million of letters of credit outstanding as of December 31, 2011.

Total bank loan borrowed funds outstanding as of March 31, 2012, including term loan borrowings and revolving loan borrowings, were approximately $171.4 million. Total bank loan borrowed funds outstanding as of December 31, 2011 were $164.2 million.

We pay interest on the term loan borrowings and revolving loan borrowings at LIBOR plus a base margin or at a base rate (typically the prime rate) plus a base margin. The LIBOR base margin as of March 31, 2012 is 2.25% and the base rate base margin as of March 31, 2012 is 0.5%. The base margins may increase or decrease in steps as our Total Funded Debt/EBITDA Ratio increases or decreases.

We have employed interest rate hedges on a significant portion of our outstanding borrowings. In July 2011, we entered into a three-year amortizing LIBOR interest rate swap on the term loan debt for an initial amount of $101 million. The swap amount amortizes as the term loan amortizes, with reductions in the swap amount occurring on the same dates and for approximately the same amounts as term loan repayments. With the swap in place, we pay an effective rate on the hedged term debt of 0.56% plus our base margin from July 2011 through June 2012, and an effective rate of 1.615% plus our base margin from July 2012 through June 2014. In July 2011, we entered into a two-year LIBOR interest rate swap on the revolving loan debt for an initial amount of $40 million. The swap amount declines to $20 million in June 2012, and expires in June 2013. With the swap in place, we will pay an effective rate on the hedged revolving loan debt of 0.7775% plus our base margin during the two years.

As of March 31, 2012, interest rates on portions of our outstanding debt ranged from 2.49% to 3.75%. The effective interest rate on our aggregate outstanding debt after taking into account the impact of the interest rate hedges was 2.86%.

Interest expense incurred on bank loan borrowings was approximately $1.3 million and $161 thousand for the three months ended March 31, 2012 and 2011, respectively.

The loan agreement contains collateral requirements that secure our assets, restrictive covenants, other affirmative and negative covenants, and subjects us to certain conditions and limitations. Restrictive covenants include a maximum Total Funded Debt/EBITDA Ratio, which decreases over time, and a minimum Fixed Charge Coverage Ratio. We were in compliance with required ratios and other loan agreement terms and conditions at March 31, 2012.

(3) Stock-based Compensation

In January of every year since 2007, we have notified certain employees that they are eligible to receive restricted stock awards under the 2006 Restricted Stock Plan based on financial performance for the respective fiscal years. These awards are expensed and a corresponding liability is recorded ratably over the vesting period of approximately three years. Upon issuance of restricted stock on each vesting date, the liability is reduced and additional paid-in capital is increased. On March 1, 2012, the employees eligible for the restricted stock awards based on the financial performance of 2009, 2010 and 2011, received a total of 29,379 shares of restricted common stock.

We also have awarded restricted stock to our non-employee Directors under the 2004 Non-Employee Directors Stock Plan. On January 3, 2012, the non-employee Directors received 10,800 shares of restricted common stock. Compensation expense related to this award was approximately $272 thousand.

The compensation expense related to all restricted stock awards discussed above and included in contract costs for the three months ended March 31, 2012 and 2011 was approximately $517 thousand and $525 thousand, respectively.

The stock-based compensation amount of approximately $185 thousand and $164 thousand shown on the accompanying statements of cash flows for the three months ended March 31, 2012 and 2011, respectively, is based on the compensation expense included in contract costs reduced by the tax withholding associated with the awards issued during the three months ended March 31, 2012 and 2011, respectively.

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(4) Earnings Per Share

Basic earnings per share (“EPS”) have been computed by dividing net income by the weighted average number of shares of common stock outstanding during each period. Shares issued during the period are weighted for the portion of the period that they were outstanding. Our calculation of diluted earnings per common share includes the dilutive effects for the assumed vesting of restricted stock awards.

During the first quarter of 2012, we determined that our restricted stock awards should be included in our diluted weighted average common shares outstanding. We have corrected the diluted weighted average common shares outstanding as of March 31, 2011 to include the dilutive effect of the restricted stock awards. The effect of this change was inconsequential to the March 31, 2011 financial statements.

	Three Months ended March 31,	
	2012	2011
Basic weighted average common shares outstanding	5,267,098	5,214,334
Effect of dilutive restricted stock awards	25,434	27,529
Diluted weighted average common shares outstanding	5,292,532	5,241,863

(5) Commitments and Contingencies

(a) Leases, Related Party Transactions and Other Commitments

We are the tenant under capital leases on four building facilities with an aggregate obligation of approximately $6.6 million as of March 31, 2012. We lease two of the facilities from a company and the other two facilities from a partnership in which certain employees of our subsidiary WBI or their direct relatives have full ownership. The leases were entered into in June 2011 in connection with our acquisition of WBI and each have terms of 15 years with two seven-year renewal options. The annual combined base rent amount is approximately $854 thousand and the leases contain escalation provisions for future years. Beginning in year five, the rent amount will increase by the greater of the Consumer Price Index (“CPI”) increase during the first four year period or 12%. For each successive lease year, the rent will increase based on any increase in the CPI for the previous lease year. The leases provide us with an option to purchase three of the facilities for a total of approximately $9 million and an option to purchase the fourth facility for approximately $650 thousand. The closing for these purchase options must occur before December 1, 2025. Depreciation and interest expense for the three months ended March 31, 2012 was approximately $112 thousand and $176 thousand, respectively.

We signed a lease in November 2009 for a building that will serve as our headquarters beginning in the spring of 2012. Certain terms in the lease agreement resulted in the capitalization of construction costs due to specific accounting rules. We have recorded a construction asset and corresponding long-term liability of approximately $26.7 million and $26.4 million, respectively, on the accompanying March 31, 2012 and December 31, 2011 condensed consolidated balance sheets in connection with this lease, which represents the construction costs incurred by the landlord as of the respective balance sheet dates.

(b) Contingencies

We entered into an agreement with a subcontractor in March 2011 to satisfy certain work share requirements (the "Agreement"). The Agreement, requires us to provide the subcontractor with certain levels of subcontracted work over two specified nine-month periods. The first period began March 1, 2011 and ended November 30, 2011. The second period began December 1, 2011 and ends August 31, 2012. As required by the Agreement, we placed $1.5 million in an escrow account to ensure cash payments to the subcontractor if the work share requirements are not satisfied.

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Due to delays in contract awards and protests of contracts awarded to us, we were not able to provide any of the first period required work to the subcontractor by November 30, 2011. Accordingly, we recorded an expense of $750 thousand on our financial statements during the third quarter of 2011. The remaining $750 thousand of escrowed funds are classified as other current assets on our March 31, 2012 balance sheet.

We have, in the normal course of business, certain claims against us and against other parties and we may be subject to various governmental investigations. In our opinion, the resolution of these claims and investigations will not have a material adverse effect on our results of operations or financial position. However, the results of any legal proceedings cannot be predicted with certainty.

(6) Business Segments and Customer Information

Business Segments

Management of our business operations is conducted under five reportable operating segments:

Federal Group - Our Federal Group provides legacy equipment sustainment, engineering, technical, management, integrated logistics support and information technology services to DoD and other government agencies.

International Group - Our International Group provides engineering, industrial, logistics and foreign military sales services to the DoD and other government agencies.

IT, Energy and Management Consulting Group – Our IT, Energy and Management Consulting Group provides technical and consulting services primarily to various civilian government agencies.

Infrastructure Group – Our Infrastructure Group is engaged principally in providing diversified technical and management services to the government, including transportation infrastructure services and aerospace services.

Supply Chain Management Group – Our Supply Chain Management Group supplies vehicle parts. This group includes WBI, which was acquired on June 6, 2011.

These segments operate under separate management teams and financial information is produced for each segment. The business entities within each of our segments meet the aggregation of operating segments criteria as defined by the accounting standard for segment reporting. We evaluate segment performance based on consolidated revenues and profits or losses from operations before income taxes. Net sales of our business segments exclude intersegment sales as these activities are eliminated in consolidation.

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VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
March 31, 2012

Our segment information for the three months ended March 31, 2012 and 2011 is as follows (in thousands):

	Three Months ended March 31, 2012	2011
Revenues:		
Federal Group	$30,755	$66,348
International Group	45,764	51,710
IT, Energy and Management Consulting Group	25,738	27,363
Infrastructure Group	4,354	5,823
Supply Chain Management Group	37,730	-
Total revenues	$144,341	$151,244
Operating income:		
Federal Group	$1,410	$2,544
International Group	1,516	1,916
IT, Energy and Management Consulting Group	3,081	2,344
Infrastructure Group	(150)	232
Supply Chain Management Group	6,756	-
Corporate/unallocated expenses	(270)	(127)
Operating income	$12,343	$6,909

Customer Information

Our revenue by customer is as follows (in thousands):

Source of Revenues	Three Months ended March 31, 2012	2011
Army/Army Reserve	$46,379	$75,648
Navy	29,955	36,090
U.S. Postal Service	34,307	-
Department of Treasury	8,626	11,650
Department of Transportation	2,069	3,504
Other	23,005	24,352
Total revenues	$144,341	$151,244

(7) Wheeler Bros., Inc. Acquisition

On June 6, 2011, we acquired WBI, a supply chain management company headquartered in Somerset, PA. WBI supplies vehicle parts to the USPS and DoD. We see significant opportunities for leveraging WBI's supply chain capabilities with our work of extending the service lives of legacy ships, vehicles, aircraft and their systems.

Cash paid at closing was $180 million, which includes approximately $1.9 million of prepaid retention bonuses that are being expensed in the post-acquisition period as the employees provide service. As such, the initial cash purchase price was approximately $178.1 million. WBI's results of operations are included in the accompanying Unaudited Condensed Consolidated Statements of Income beginning June 6, 2011. Additional cash consideration of $3 million was paid to the sellers during the first quarter of 2012 based on the final working capital adjustment that was recorded as additional goodwill and an accrued liability during December 2011.

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We may be required to make additional payments of up to $40 million over a four-year post-closing period if WBI achieves certain financial performance targets. Included in earn-out obligations on the March 31, 2012 balance sheet is an earn-out liability of approximately $9.2 million, net of the current portion of $6.6 million classified in current portion of earn-out obligations, which represents our best estimate of the present value of the earn-out obligation. Interest expense and subsequent changes in the fair value of the earn-out obligations will be recognized in earnings in the period of change through settlement.

(8) Goodwill and Intangible Assets

There were no changes in goodwill for the three months ended March 31, 2012. Goodwill by operating segment as of December 31, 2011 and March 31, 2012 is as follows (in thousands):

	Supply Chain Management	IT, Energy and Management Consulting	Infrastructure	Total
Balance as of December 31, 2011	$ 61,169	$ 30,883	$ 6,827	$98,879
Balance as of March 31, 2012	$ 61,169	$ 30,883	$ 6,827	$98,879

Intangible assets consist of the value of contract-related intangible assets and trade names acquired in the acquisitions of Integrated Concepts and Research Corporation ("ICRC"), G&B Solutions, Inc. ("G&B"), Akimeka, LLC and WBI. Intangible assets with indefinite lives, not subject to amortization, consist of ICRC and G&B trade names of approximately $2.4 million as of March 31, 2012 and December 31, 2011. The trade names acquired in the Akimeka and WBI acquisitions are being amortized over nine years. Amortization expense for the three months ended March 31, 2012 and 2011 was approximately $2.8 million and $863 thousand, respectively.

Intangible assets were comprised of the following (in thousands):

March 31, 2012	Cost	Accumulated Amortization	Net Intangible Assets
Contract-related	$96,884	$ (15,252)	$81,632
Acquired technologies	12,400	(924)	11,476
Trade name – amortizable	9,170	(974)	8,196
Trade names – indefinite lived	2,430	-	2,430
Total	$120,884	$ (17,150)	$103,734

December 31, 2011	Cost	Accumulated Amortization	Net Intangible Assets
Contract-related	$96,884	$ (12,987)	$83,897

Acquired technologies	12,400