HEALTH FITNESS CORP /MN/
Form 10-Q
November 08, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

# FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004

COMMISSION FILE NO. 000-25064

HEALTH FITNESS CORPORATION
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| | |
|---|---|
| MINNESOTA | NO. 41-1580506 |
| (STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION) | (IRS EMPLOYER IDENTIFICATION NO.) |

3600 AMERICAN BOULEVARD WEST, BLOOMINGTON, MINNESOTA 55431
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

REGISTRANT'S TELEPHONE NUMBER (952) 831-6830

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the 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 Exchange Act Rule 12b-2). YES [ ] NO [X]

The number of shares outstanding of the registrant's common stock as of November 5, 2004 was: Common Stock, $0.01 par value, 12,560,976 shares

HEALTH FITNESS CORPORATION
CONSOLIDATED FINANCIAL STATEMENTS
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HEALTH FITNESS CORPORATION
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

| | September 30, 2004 |
|---|---|
| ASSETS | |
| CURRENT ASSETS | |
| Cash | $ 206,458 |
| Trade and other accounts receivable, less allowances of $154,400 and $131,000 | 7,913,590 |

| | |
|---|---|
| Prepaid expenses and other | 244,179 |
| Deferred taxes | 1,294,300 |
| Total current assets | 9,658,527 |
| PROPERTY AND EQUIPMENT, net | 161,714 |
| OTHER ASSETS | |
| Goodwill | 9,022,501 |
| Customer contracts, less accumulated amortization of $673,600 and $67,400 | 1,056,389 |
| Trademark, less accumulated amortization of $58,300 and $5,800 | 291,666 |
| Other intangible assets, less accumulated amortization of $26,800 and $4,200 | 115,990 |
| Cash held in escrow | - |
| Deferred taxes | 513,382 |
| Other | 41,275 |
| | $ 20,861,444 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | |
| CURRENT LIABILITIES | |
| Trade accounts payable | $ 349,129 |
| Accrued salaries, wages, and payroll taxes | 2,635,743 |
| Other accrued liabilities | 510,655 |
| Accrued self funded insurance | 497,043 |
| Deferred revenue | 1,525,068 |
| Total current liabilities | 5,517,638 |
| LONG-TERM OBLIGATIONS | 2,666,353 |
| COMMITMENTS AND CONTINGENCIES | - |
| CUMULATIVE CONVERTIBLE PREFERRED STOCK, 10,000,000 shares authorized, 1,048,874 and 1,003,833 issued and outstanding | 1,508,632 |
| STOCKHOLDERS' EQUITY | |
| Common stock, $0.01 par value; 50,000,000 shares authorized; 12,560,976 and 12,357,334 shares issued and outstanding | 125,609 |
| Additional paid-in capital | 17,836,886 |
| Accumulated comprehensive income | 2,544 |
| Accumulated deficit | (6,796,218 |
| | 11,168,821 |
| | $ 20,861,444 |

See notes to consolidated financial statements.

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HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF EARNINGS
(UNAUDITED)

| | Three Months Ended | Nine Month |
|---|---|---|

| | September 30, | | Septembe |
|---|---|---|---|
| | 2004 | 2003 | 2004 |
| REVENUE | $ 13,154,340 | $ 7,445,094 | $ 38,950,429 |
| COSTS OF REVENUE | 9,807,257 | 5,979,326 | 29,074,051 |
| GROSS PROFIT | 3,347,083 | 1,465,768 | 9,876,378 |
| OPERATING EXPENSES | | | |
| Salaries | 1,408,482 | 834,781 | 4,180,760 |
| Other selling, general and administrative | 784,560 | 393,018 | 2,438,170 |
| Amortization of acquired intangible assets | 219,583 | - | 658,750 |
| Total operating expenses | 2,412,625 | 1,227,799 | 7,277,680 |
| OPERATING INCOME | 934,458 | 237,969 | 2,598,698 |
| OTHER INCOME (EXPENSE ) | | | |
| Interest expense | (118,102) | (59,031) | (380,698) |
| Other, net | 908 | (32,949) | 2,298 |
| EARNINGS BEFORE INCOME TAXES | 817,264 | 145,989 | 2,220,298 |
| INCOME TAX EXPENSE | 330,500 | 58,203 | 882,873 |
| NET EARNINGS | 486,764 | 87,786 | 1,337,425 |
| Dividend to preferred shareholders | 21,600 | - | 64,800 |
| NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS | $ 465,164 | $ 87,786 | $ 1,272,625 |
| NET EARNINGS PER SHARE: | | | |
| Basic | $ 0.04 | $ 0.01 | $ 0.10 |
| Diluted | 0.03 | 0.01 | 0.08 |
| WEIGHTED AVERAGE COMMON SHARES: | | | |
| Basic | 12,550,679 | 12,341,284 | 12,482,060 |
| Diluted | 16,122,175 | 12,743,441 | 16,078,873 |

See notes to consolidated financial statements.



HEALTH FITNESS CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | Nine Months En September 30 |
|---|---|
| | 2004 |

| | | |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net earnings | $ 1,337,425 | $ |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation of property and equipment | 71,520 | |
| Amortization of intangible assets and other | 746,171 | |
| Deferred taxes | 728,917 | |
| Common stock issued for compensation | 60,600 | |
| Changes in operating assets and liabilities, net of assets acquired: | | |
| Trade and other accounts receivable | (2,695,366) | |
| Prepaid expenses and other | (96,832) | |
| Other assets | 23,183 | |
| Trade accounts payable | (223,765) | |
| Accrued liabilities and other | 1,357,945 | |
| Deferred revenue | 98,011 | |
| Net cash provided by operating activities | 1,407,809 | 1 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of property and equipment | (56,017) | |
| Acquisition of business | (256,927) | |
| Net cash used in investing activities | (312,944) | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Borrowings under note payable | 13,087,343 | 2 |
| Repayments of note payable | (14,835,830) | (2 |
| Proceeds from issuance of common stock | 71,540 | |
| Proceeds from the exercise of stock options | 35,247 | |
| Proceeds from closing cash escrow account | 471,999 | |
| Proceeds from the issuance of bridge note financing | - | 3 |
| Payment to cash escrow account | - | (3 |
| Payment of financing costs | - | |
| Net cash used in financing activities | (1,169,701) | |
| NET INCREASE (DECREASE) IN CASH | (74,836) | |
| CASH AT BEGINNING OF PERIOD | 281,294 | |
| CASH AT END OF PERIOD | $ 206,458 | $ |

SUPPLEMENTAL CASH FLOW DISCLOSURES

| | | |
|---|---|---|
| Supplemental cash flow information | | |
| Cash paid for interest | $ 293,226 | $ |
| Cash paid for taxes | 116,365 | |
| Noncash investing and financing activities affecting cash flows: | | |
| Dividend to preferred shareholders | 64,800 | |
| Proceeds from Wells Loan escrowed for pending acquisition | - | 2 |

See notes to consolidated financial statements.

HEALTH FITNESS CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. They should be read in conjunction with the annual financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003. In the opinion of management, the interim consolidated financial statements include all adjustments (consisting of normal recurring accruals) necessary for the fair presentation of the results for interim periods presented. Operating results for the three and nine months ended September 30, 2004 are not necessarily indicative of the operating results for the year ending December 31, 2004.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business - Health Fitness Corporation and its wholly owned subsidiaries (the Company) provide fitness and wellness management services and programs to corporations, hospitals, communities and universities located in the United States and Canada. Fitness and wellness management services include the development, marketing and management of corporate, hospital, community and university based fitness centers, injury prevention and work-injury management consulting, and on-site physical therapy. Programs include wellness and health programs for individual customers, including health risk assessments, nutrition and weight loss programs, smoking cessation, massage therapy, back care and ergonomic injury prevention.

Consolidation - The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Cash - The Company maintains cash balances at several financial institutions, and at times, such balances exceed insured limits. The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash.

Trade and Other Accounts Receivable - Trade and other accounts receivable represent amounts due from companies and individuals for services and products. The Company grants credit to customers in the ordinary course of business, but generally does not require collateral or any other security to support amounts due. Management performs ongoing credit evaluations of customers. The Company determines its allowance for discounts and doubtful accounts by considering a number of factors, including the length of time trade accounts receivable are past due, the Company's previous loss history, the customer's current ability to pay its obligation to the Company, and the condition of the general economy and the industry as a whole. The Company writes off accounts receivable when they become uncollectible, and payments subsequently received on such receivable are credited to the allowance. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers and their geographic dispersion.

Property and Equipment - Property and equipment are stated at cost. Depreciation and amortization are computed using both straight-line and accelerated methods over the useful lives of the assets.

Goodwill - Goodwill represents the excess of the purchase price and related costs over the fair value of net assets of businesses acquired. The carrying value of goodwill is not amortized, but is tested for impairment on an annual basis or when factors indicating impairment are present. Projected discounted cash flows are used in assessing these assets.

Intangible Assets - The Company's intangible assets include customer contracts, trademark, and deferred financing costs and are amortized on a straight-line basis. Customer contracts represent the fair value assigned to acquired management contracts and are amortized over the remaining life of the contracts, of which 26



months remain at September 30, 2004. Trademark represents the value assigned to an acquired trademark and is amortized over a period of five years. Deferred financing costs are amortized over the term of the related credit agreement.

Cash Held In Escrow - Cash held in escrow at December 31, 2003 represented the funds remaining after payment of the purchase price for the Company's December 2003 acquisition. In September 2004, the parties subject to the escrow agreement agreed that all conditions to the acquisition had been satisfied, at which time the remaining funds of $474,610 were remitted to the Company.

Revenue Recognition - Revenue is recognized at the time the service is provided to the customer. For annual contracts, monthly amounts are recognized ratably over the term of the contract. Certain services provided to the customer may vary on a periodic basis and are invoiced to the customer in arrears. The revenues relating to these services are estimated in the month the service is performed based on the cost of the services.

Amounts received from customers in advance of providing the services of the contract are recorded as deferred revenue and recognized when the services are provided.

The Company has contracts with third-parties (e.g. janitorial services) to provide ancillary services in connection with their fitness and wellness management services and programs. Under such arrangements the third-parties invoice and receive payments from the Company based on services provided to the ultimate customer. The Company does not recognize revenues related to such transactions as the ultimate customer assumes the risk and rewards of the contract and the amounts billed to the customer are either at cost or with a fixed markup.

Comprehensive Income - Comprehensive income represents net earnings adjusted for foreign currency translation adjustments. Total comprehensive income was $1,269,462 and $573,099 for the nine months ended September 30, 2004 and 2003.

Net Earnings Per Share - Basic net earnings per share is computed by dividing net earnings applicable to common shareholders by the number of weighted average common shares outstanding. Diluted net earnings per share is computed by dividing net earnings applicable to common shareholders plus dividends to preferred shareholders (net earnings) by the number of weighted average common shares outstanding, and common share equivalents relating to stock options and stock warrants, when dilutive.

Common stock options and warrants to purchase 470,100 and 342,442 shares of common stock were excluded from the three months ended September 30, 2004 and 2003 calculation, and 365,100 and 658,359 shares were excluded from the nine month ended September 30, 2004 and 2003 calculation because they are anti-dilutive.

Stock-based Compensation - The Company utilizes the intrinsic value method of accounting for its stock based employee compensation plans. All options granted had an exercise price equal to the market value of the underlying common stock on the date of grant and accordingly, no compensation cost is reflected in net earnings for the three and nine months ended September 30, 2004 and 2003. The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value method of accounting for stock options:

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| | Three Months ended September 30, | | Nine Months ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| Net earnings, applicable to common Shareholders - basic | $ 465,164 | $ 87,786 | $ 1,272,625 | $ 573,099 |
| Add: Dividends to preferred shareholders | 21,600 | - | 64,800 | - |
| Net earnings - diluted | 486,764 | 87,786 | 1,337,425 | 573,099 |
| Less: Compensation expense determined under the fair value method, net of tax | (23,445) | (17,810) | (137,438) | (55,116 |
| Proforma net earnings - basic | $ 441,719 | $ 69,976 | $ 1,135,187 | $ 517,983 |
| Proforma net earnings - diluted | $ 463,319 | $ 69,976 | $ 1,199,987 | $ 517,983 |
| Earnings per Share: | | | | |
| Basic, as reported | $ 0.04 | $ 0.01 | $ 0.10 | $ 0.05 |
| Basic, proforma | $ 0.04 | $ 0.01 | $ 0.09 | $ 0.04 |
| Diluted, as reported | $ 0.03 | $ 0.01 | $ 0.08 | $ 0.05 |
| Diluted, proforma | $ 0.03 | $ 0.01 | $ 0.07 | $ 0.04 |

The proforma information above should be read in conjunction with the related historical information.

The fair value of each option grant is estimated on the grant date using the Black-Scholes option-pricing model with the following assumptions and results for the grants:

| | 2004 | 2003 |
|---|---|---|
| Dividend yield | None | None |
| Expected volatility | 88% | 90-105% |
| Expected life of option | 1-4 years | 1-4 years |
| Risk-free interest rate | 3.27% | 2.9% |

| | | |
|---|---|---|
| Weighted average fair value of options on grant date | $ 1.01 | $ 0.24 |

Fair Values of Financial Instruments - Due to their short-term nature, the carrying value of the Company's current financial assets and liabilities approximates their fair values. The fair value of long-term obligations, if recalculated based on current interest rates, would not significantly differ from the recorded amounts.

Use of Estimates - Preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 3. PURCHASE OF ASSETS

On December 8, 2003 (the "Effective Date"), the Company purchased the business assets of the Health & Fitness Services Business of Johnson & Johnson Health Care Systems Inc. (JJHCS). Assets acquired by the Company consist primarily of client contracts, proprietary wellness, lifestyle and health promotion programs, software, and other health and wellness services. As part of the transaction, the Company entered into a multi-year management contract with another subsidiary of Johnson & Johnson whereby the Company will manage more than 50 Johnson & Johnson affiliate fitness center sites. The Company also entered into a one-year agreement to use 660 square feet of office space of JJHCS for a fee of $1,500 per month.



The fair market value of the assets acquired resulted in the following purchase price allocation:

| | |
|---|---|
| Cash price paid for assets | $4,990,862 |
| Acquisition costs incurred | 836,879 |
| Total purchase price | $5,827,741 |
| Purchase Price Allocation | |
| Inventory | $ -- |
| Property and equipment | 34,000 |
| Customer contracts | 1,730,000 |
| Trademark | 350,000 |
| Excess of cost over assets acquired | 3,713,741 |
| | $5,827,741 |

During the nine months ended September 30, 2004, an additional $205,473 was paid to JJHCS for four contract assignments. The Company also incurred an additional $51,455 of acquisition related costs. During the quarter ended September 30, 2004, the Company determined that $40,000 previously allocated to inventory was obsolete. These additional amounts were recorded to goodwill.

NOTE 4. FINANCING

On August 22, 2003, the Company entered into a $7,500,000 Credit Agreement with Wells Fargo Bank, N.A. to provide the Company with acquisition financing and general working capital (the Wells Loan). The initial draw on the Wells Loan totaled $1,255,204, which was used to refinance a revolving line of credit with Merrill Lynch Business Financial Services, Inc. (the Merrill Lynch Loan). The Company repaid all amounts owed to Merrill Lynch Business Financial Services, Inc. and canceled the line of credit, which accrued interest at the one-month LIBOR rate plus 2.35%. On August 25, 2003, the Company made a draw of $2,250,000 on the Wells Loan, the proceeds of which were placed into escrow to fund a portion of the JJHCS asset purchase.

Working capital advances from the Wells Loan are based upon a percentage of the Company's eligible accounts receivable, less any amounts previously drawn. At the option of the Company, the Wells Loan bears interest at prime or the one-month LIBOR plus a margin of 2.25% to 2.75% based upon the Company's Senior Leverage Ratio (effective rate of 4.75% at September 30, 2004 and 4.00% at December 31, 2003). The availability of the Wells Loan will decrease $250,000 on the last day of each calendar quarter, beginning September 30, 2003, and will expire on June 30, 2007. Borrowing capacity under the Wells Loan totaled $6,250,000 and $7,000,000 at September 30, 2004 and December 31, 2003. At September 30, 2004, the Company had $1,026,513 outstanding under the Wells Loan. Borrowings under the Wells Loan are collateralized by substantially all of the Company's assets. The Company is required to comply with certain monthly financial covenants, including a fixed charge coverage ratio, minimum earnings before interest, taxes, depreciation and amortization, cash flow leverage ratio and a balance sheet leverage ratio. Beginning on January 31, 2004 and continuing to May 14, 2004, the Company was not in compliance with certain covenants relating to the Wells Loan. On May 14, 2004, Wells Fargo agreed to waive the noncompliance and amend the loan covenants, effective as of January 31, 2004. The Company believes the new loan covenants are more appropriate after taking into consideration the Company's actual financial position following the acquisition of the business assets of JJHCS. Wells Fargo was made aware of the noncompliance shortly after January 31, 2004 and agreed to continue making capital advances to the Company throughout the period as new loan covenants were negotiated. Therefore, the noncompliance had no impact on the Company's liquidity, capital resources or results of operations. At September 30, 2004, the Company was in compliance with all of its loan covenants.

On August 25, 2003, the Company entered into a $3,000,000 Securities Purchase Agreement with Bayview Capital Partners LP ("Bayview") to provide the Company with acquisition financing and general working

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capital (the "Bayview Investment"). The Bayview Investment was initially structured as a bridge note (the "Bridge Note"), the proceeds of which were placed into escrow to fund a portion of the JJHCS asset purchase.

On December 8, 2003 (the "Effective Date"), the $3,000,000 Bridge Note issued to Bayview was converted into a $2,000,000 term note (the "Term Note"), $1,000,000 of Series A Convertible Preferred Stock, $0.01 par value (the "Preferred Stock") and a warrant to purchase common stock of the Company (the "Warrant") per the terms set forth in the August 25, 2003 Securities Purchase Agreement. The Term Note bears interest at 12% per year, payable monthly, and will mature on December 8, 2008. The Term Note may be prepaid, in whole or in part, at any time, provided that the prepayment is accompanied by a premium ranging from 5% in year 1 to 1% in year 5. The Bayview Investment is secured by a subordinated security interest in substantially all of the Company's assets. The Bayview Investment contained identical financial covenants to those in the Wells Loan described above, and on May 14, 2004 Bayview agreed to join with Wells Fargo in waiving this noncompliance and amending the covenants. The noncompliance with these financial covenants had no impact on the Company's liquidity, capital resources or results of operations, and the Company believes the amended covenants are more appropriate after taking into consideration the Company's actual financial position following the acquisition of the business assets of JJHCS. At September 30, 2004, the Company was in compliance with all of its loan covenants.

The Preferred Stock was issued to Bayview at a price of $1.00 per share, resulting in 1,000,000 shares issued on the Effective Date. The Preferred Stock has a stated dividend rate of 6% per year, computed on a simple interest basis, paid in kind in the form of additional shares of Preferred Stock using a price of $1.00 per share ("PIK Dividends"). At the option of the holder, the Preferred Stock, including any PIK Dividends, may be converted, at any time and from time to time, into common stock of the Company at a price of $0.50 per share. In addition, Bayview may require redemption of the Preferred Stock and PIK Dividends upon a change of control or default (including default under the Term Note).

The Warrant issued to Bayview on the Effective Date represents the right to purchase 1,210,320 shares of common stock, which represented 8% of the Company's common stock outstanding on a fully diluted basis at the Effective Date, excluding the common stock issuable to Bayview upon conversion of the Preferred Stock. The Warrant is exercisable at any time for a period of ten years at an exercise price equal to $0.50 per share, and the shares obtainable upon exercise of the Warrant may be put to the Company at fair market value (net of the exercise price) upon a change of control or default.

The investment proceeds received from Bayview were allocated based upon the relative fair value of each instrument, which resulted in the following allocation:

| | |
|---|---|
| Value assigned to Preferred Stock | $ 783,904 |
| Value assigned to Warrants | 648,288 |
| Value assigned to Term Note | 1,567,808 |
| | $ 3,000,000 |

The $432,192 difference between the $2,000,000 face value of the Term Note and its assigned relative fair value is being amortized as interest expense over the 5-year term of the Term Note. Balances of long-term obligations are as follows:



| | September 30, 2004 | December 31, 2003 |
|---|---|---|
| Wells Loan | $ 1,026,513 | $ 2,775,000 |
| Bayview Term Note | 2,000,000 | 2,000,000 |
| | 3,026,513 | 4,775,000 |
| Discount on Bayview Term Note | (360,160) | (424,988) |
| | $ 2,666,353 | $ 4,350,012 |

Outstanding principal balances on the Wells Loan and Bayview Term Note mature in June 2007 and August 2008, respectively.

NOTE 5. INCOME TAXES

The Company records income taxes in accordance with the liability method of accounting. Deferred income taxes are provided for temporary differences between the financial reporting and tax basis of assets and liabilities and federal operating loss carryforwards. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of the enactment. Income taxes are calculated based on management's estimate of the Company's effective tax rate, which takes into consideration a federal tax rate of 34% and a blended state tax rate of 6%.

NOTE 6. STOCK OPTIONS

The Company maintains a stock option plan for the benefit of certain eligible employees and directors of the Company. A total of 1,537,350 shares of common stock are reserved for additional grants of options under the plan at September 30, 2004. Generally, the options outstanding (1) are granted at prices equal to the market value of the stock on the date of grant, (2) vest over various terms and, (3) expire over a period of five or ten years from the date of grant.

A summary of stock option activity for the nine months ended September 30, 2004 is as follows:

| | Number of Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding at December 31, 2003 | 1,710,900 | $0.88 |
| Granted | 165,100 | 2.07 |
| Exercised | (59,750) | 0.53 |
| Forfeited | (31,250) | 0.44 |
| Outstanding at March 31, 2004 | 1,785,000 | 1.01 |
| Granted | 120,000 | 1.51 |
| Exercised | (6,350) | 0.53 |
| Forfeited | (1,350) | 0.47 |
| Outstanding at June 30, 2004 | 1,897,300 | 1.04 |
| Forfeited | (5,000) | 0.38 |
| Outstanding at September 30, 2004 | 1,892,300 | 1.04 |



ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included in Item 1 of Part 1 of this Quarterly Report and the audited consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of

Operations contained in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2003.

CRITICAL ACCOUNTING POLICIES. Our most critical accounting policies, which are those that require significant judgment, include: revenue recognition, trade and other accounts receivable, goodwill and stock-based compensation. A more in-depth description of these can be found in our Annual Report on Form 10-K for the fiscal year ended December 31, 2003.

GENERAL. Health Fitness Corporation and its wholly owned subsidiaries (the Company), provide fitness and wellness management services and programs to corporations, hospitals, communities and universities located in the United States of America and Canada. Fitness and wellness management services include the development, marketing and management of corporate, hospital, community and university-based fitness centers, injury prevention and work-injury management consulting, and on-site physical therapy and occupational health services. Programs include wellness and health programs for individual customers, including health risk assessments, nutrition and weight loss programs, smoking cessation, massage therapy, back care and ergonomic injury prevention.

RESULTS OF OPERATIONS FOR THE QUARTER ENDED SEPTEMBER 30, 2004 AS COMPARED TO THE QUARTER ENDED SEPTEMBER 30, 2003.

REVENUE. Revenues increased $5,709,000, or 76.7%, to $13,154,000 for the three months ended September 30, 2004, from $7,445,000 for the three months ended September 30, 2003. This increase is primarily attributed to the December 2003 acquisition of the business assets of the Health & Fitness Services Business of Johnson & Johnson Health Care Systems Inc. ("JJHCS").

GROSS PROFIT. Gross profit increased $1,881,000, or 128.3%, to $3,347,000 for the three months ended September 30, 2004, from $1,466,000 for the three months ended September 30, 2003. This increase is primarily attributed to the acquisition of JJHCS. In addition, primarily as a result of the JJHCS acquisition, gross profit as a percent of revenue increased to 25.4% for the three months ended September 30, 2004, compared to 19.7% for the three months ended September 30, 2003.

OPERATING EXPENSES. Operating expenses increased $1,185,000 to $2,413,000 for the three months ended September 30, 2004, from $1,228,000 for the three months ended September 30, 2003. Of this increase, $220,000 represents a non-cash expense related to the amortization of acquired intangible assets. The remaining increase of $965,000 is primarily attributed to the cost of salaries, benefits and other expenses of the JJHCS management team.

OTHER INCOME AND EXPENSE. Interest expense increased $59,000 to $118,000 for the three months ended September 30, 2004, from $59,000 for the same period in 2003. This increase is due to debt facilities the company secured to finance the JJHCS acquisition and to provide working capital for the combined company. The Company's cost of borrowed funds increased to an average of 9.76% for the third quarter of 2004 from 3.5% for the third quarter of 2003.

INCOME TAXES. Income tax expense increased $272,000 to $330,000 for the three months ended September 30, 2004 compared to $58,000 for the same period in 2003. The increase is due to the increase in operating profit.

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DIVIDENDS TO PREFERRED SHAREHOLDERS. To finance the Company's acquisition of JJHCS, the Company sold $1,000,000 of Preferred Stock to Bayview. The Preferred Stock was issued at a price of $1.00 per share, resulting in the issuance of 1,000,000 shares. The Preferred Stock has a stated dividend rate of 6% per year, computed on a simple interest basis, paid in kind in the form of additional shares of Preferred Stock using a price of $1.00 per share ("PIK Dividends"). For the quarter ended September 30, 2004, the Company accrued dividends of $22,000, including a dividend of approximately $7,000 related to a beneficial conversion feature associated with the PIK Dividends.

NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS. As a result of the above, net earnings applicable to common shareholders for the three months ended September 30, 2004 increased $377,000, or 428.4%, to $465,000, from $88,000 for the three months ended September 30, 2003.

RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2004 AS COMPARED TO THE NINE MONTHS ENDED SEPTEMBER 30, 2003.

REVENUE. Revenues increased $16,254,000, or 71.6%, to $38,950,000 for the nine months ended September 30, 2004, from $22,696,000 for the nine months ended September 30, 2003. This increase is primarily attributed to the acquisition of JJHCS.

GROSS PROFIT. Gross profit increased $5,175,000, or 110.1%, to $9,876,000 for the nine months ended September 30, 2004, from $4,701,000 for the nine months ended September 30, 2003. This increase is primarily attributed to the acquisition of JJHCS. In addition, primarily as a result of the JJHCS acquisition, gross profit as a percent of revenue increased to 25.4% for the nine months ended September 30, 2004, compared to 20.7% for the nine months ended September 30, 2003.

OPERATING EXPENSES. Operating expenses increased $3,647,000 to $7,278,000 for the nine months ended September 30, 2004, from $3,631,000 for the nine months ended September 30, 2003. Of this increase, $659,000 represents a non-cash expense related to the amortization of acquired intangible assets. The remaining increase of $2,988,000 is primarily attributed to the cost of salaries, benefits and other expenses of the JJHCS management team.

OTHER INCOME AND EXPENSE. Interest expense increased $298,000 to $381,000 for the nine months ended September 30, 2004, compared to $83,000 for the same period in 2003. This increase is due to debt facilities the company secured to finance the JJHCS acquisition and to provide working capital for the combined company. The Company's cost of borrowed funds increased to an average of 7.5% for the nine months ended September 30, 2004, from 3.6% for the same period in 2003.

INCOME TAXES. Income tax expense increased $504,000 to $883,000 for the nine months ended September 30, 2004, compared to $379,000 for the same period in 2003. The increase is due to the increase in operating profit.

DIVIDENDS TO PREFERRED SHAREHOLDERS. For the nine months ended September 30, 2004, the Company accrued dividends on the Preferred Stock held by Bayview in the amount of $65,000, including a dividend of approximately $20,000 related to a beneficial conversion feature associated with the PIK Dividends.

NET EARNINGS APPLICABLE TO COMMON SHAREHOLDERS. As a result of the above, net earnings applicable to common shareholders for the nine months ended September 30, 2004 increased $700,000, or 122.2%, to $1,273,000, from $573,000 for the nine months ended September 30, 2003.



LIQUIDITY AND CAPITAL RESOURCES

The Company's working capital increased $1,886,000 to $4,141,000 at September

30, 2004, compared to working capital of $2,255,000 at December 31, 2003. The increase in working capital is primarily due to an increase in accounts receivable resulting from the fitness and wellness management contracts acquired in the JJHCS transaction.

On August 22, 2003, the Company entered into a $7,500,000 Credit Agreement with Wells Fargo Bank, N.A. to provide the Company with acquisition financing and general working capital (the Wells Loan). The initial draw on the Wells Loan totaled $1,255,204, which was used to refinance a revolving line of credit with Merrill Lynch Business Financial Services, Inc. (the Merrill Lynch Loan). The Company repaid all amounts owed to Merrill Lynch Business Financial Services, Inc. and canceled the line of credit, which accrued interest at the one-month LIBOR rate plus 2.35%. On August 25, 2003, the Company made a draw of $2,250,000 on the Wells Loan, the proceeds of which were placed into escrow to fund a portion of the JJHCS asset purchase.

Working capital advances from the Wells Loan are based upon a percentage of the Company's eligible accounts receivable, less any amounts previously drawn. At the option of the Company, the Wells Loan bears interest at prime or the one-month LIBOR plus a margin of 2.25% to 2.75% based upon the Company's Senior Leverage Ratio (effective rate of 4.75% at September 30, 2004 and 4.00% at December 31, 2003). The availability of the Wells Loan will decrease $250,000 on the last day of each calendar quarter, beginning September 30, 2003, and will expire on June 30, 2007. Borrowing capacity under the Wells Loan totaled $6,250,000 and $7,000,000 at September 30, 2004 and December 31, 2003. At September 30, 2004, the Company had $1,026,513 outstanding under the Wells Loan. Borrowings under the Wells Loan are collateralized by substantially all of the Company's assets. The Company is required to comply with certain monthly financial covenants, including a fixed charge coverage ratio, minimum earnings before interest, taxes, depreciation and amortization, cash flow leverage ratio and a balance sheet leverage ratio. Beginning on January 31, 2004 and continuing to May 14, 2004, the Company was not in compliance with certain covenants relating to the Wells Loan. On May 14, 2004, Wells Fargo agreed to waive the noncompliance and amend the loan covenants, effective as of January 31, 2004. The Company believes the new loan covenants are more appropriate after taking into consideration the Company's actual financial position following the acquisition of the business assets of JJHCS. Wells Fargo was made aware of the noncompliance shortly after January 31, 2004 and agreed to continue making capital advances to the Company throughout the period as new loan covenants were negotiated. Therefore, the noncompliance had no impact on the Company's liquidity, capital resources or results of operations. At September 30, 2004, the Company was in compliance with all of its loan covenants.

On August 25, 2003, the Company entered into a $3,000,000 Securities Purchase Agreement with Bayview to provide the Company with acquisition financing and general working capital (the "Bayview Investment"). The Bayview Investment was initially structured as a bridge note (the "Bridge Note"), the proceeds of which were placed into escrow to fund a portion of the JJHCS asset purchase.

On December 8, 2003 (the "Effective Date"), the $3,000,000 Bridge Note issued to Bayview was converted into a $2,000,000 term note (the "Term Note"), $1,000,000 of Preferred Stock and a warrant to purchase common stock of the Company (the "Warrant") per the terms set forth in the August 25, 2003 Securities Purchase Agreement. The Term Note bears interest at 12% per year, payable monthly, and will mature on December 8, 2008. The Term Note may be prepaid, in whole or in part, at any time, provided that the prepayment is accompanied by a premium ranging from 5% in year 1 to 1% in year 5. The Bayview Investment is secured by a subordinated security interest in substantially all of the Company's assets. The Bayview Investment contained identical financial covenants to those in the Wells Loan described above, and on May 14, 2004, Bayview agreed to join with Wells Fargo in waiving this noncompliance and amending the covenants. The noncompliance with these financial covenants had no impact on the Company's liquidity, capital resources or results of operations, and the Company believes the amended covenants are more appropriate after taking into



consideration the Company's actual financial position following the acquisition of the business assets of JJHCS. At September 30, 2004, the Company was in compliance with all of its loan covenants.

The Preferred Stock was issued to Bayview at a price of $1.00 per share, resulting in 1,000,000 shares issued on the Effective Date. The Preferred Stock has a stated dividend rate of 6% per year, computed on a simple interest basis, paid in kind in the form of additional shares of Preferred Stock using a price of $1.00 per share ("PIK Dividends"). At the option of the holder, the Preferred Stock, including any PIK Dividends, may be converted, at any time and from time to time, into common stock of the Company at a price of $0.50 per share. In addition, Bayview may require redemption of the Preferred Stock and PIK Dividends upon a change of control or default (including default under the Term Note).

The Company has no off-balance sheet arrangements or transactions with unconsolidated, limited purpose entities. Refer to the footnotes in the Company's Annual Report on Form 10-K for the year ended December 31, 2003, for disclosure related to the Company's "Commitments and Contingencies."

On a short and long-term basis, the Company believes that sources of capital to meet future obligations will be provided by cash generated through operations and the Wells Loan. The Company does not believe that inflation has had a significant impact on the results of its operations.

RECENTLY ISSUED ACCOUNTING POLICIES

We are not aware of any recently issued accounting pronouncements that will have a material impact on the Company's financial position or results of operations.

RECENTLY PASSED LEGISLATION

HIPPA. The Administrative Simplification provisions of the Health Insurance Portability and Accountability Act of 1996, or HIPAA, require group health plans and health care providers who conduct certain administrative and financial transactions electronically to (a) comply with a certain data format and coding standards when conducting electronic transactions; (b) use appropriate technologies to protect the security and integrity of individually identifiable health information transmitted or maintained in an electronic format; and (c) protect the privacy of patient health information. The Company's occupational health line of business, which accounts for approximately five percent of the Company's total revenue, and the group health plan the Company sponsors for its employees are subject to HIPAA's requirements. The Company expects to be in compliance with HIPPA requirements within the timeline specified for the Company's affected business areas. The Company's corporate, hospital, community and university based fitness center management lines of business are not subject to the requirements of HIPAA.

CAUTIONARY STATEMENT

The foregoing discussion and other statements in this report contain various "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are based on current expectations or beliefs concerning future events. Such statements can be identified by the use of terminology such as "anticipate," "believe," "estimate," "expect," "intend," "may," "could," "possible," "plan," "project," "will," "forecast" and similar words or expressions, specifically including a statement regarding the Company's belief that sources of capital to meet future obligations will be provided by cash generated through operations and its Wells Loan. These forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties that may cause the Company's actual results to differ materially from the results discussed in these statements. Please refer to Management's Discussion and Analysis contained within the Company's Annual Report on Form 10-K for the year ended December 31, 2003, for cautionary statements on important factors to consider in evaluating the forward-looking statements included in this Form 10-Q.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has no history of, and does not anticipate in the future, investing in derivative financial instruments, derivative commodity instruments or other such financial instruments. Transactions with international customers are entered into in U.S. dollars, precluding the need for foreign currency hedges. As a result, the exposure to market risk is not material.

ITEM 4. CONTROLS AND PROCEDURES

The Company's Chief Executive Officer and Chief Financial Officer (collectively, the "Certifying Officers") are responsible for establishing and maintaining disclosure controls and procedures for the Company. The Certifying Officers have concluded (based upon their evaluation of these controls and procedures as of the end of the period covered by this report) that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules of the Securities and Exchange Commission. The Certifying Officers also have indicated that there were no significant changes in the Company's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Refer to Item 3 (Legal Proceedings) of the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

See Exhibit Index on page following signatures

(b) Reports on Form 8-K

On August 3, 2004, the Company filed a Form 8-K providing a press release dated August 2, 2004 regarding its 2004 second quarter financial results.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.Dated: November 8, 2004

HEALTH FITNESS CORPORATION.

By /s/ Jerry V. Noyce

Jerry V. Noyce
Chief Executive Officer
(Principal Executive Officer)

By /s/ Wesley W. Winnekins

Wesley W. Winnekins
Chief Financial Officer(Principal
Financial and Accounting Officer)

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EXHIBIT INDEX
HEALTH FITNESS CORPORATION
FORM 10-Q

| Exhibit # | Description |
|---|---|
| *10.10 | Agreement Regarding Closing of Escrow Account, by and among Health Fitness Corpora Healthcare Systems Inc., Wells Fargo Bank, National Association (as Lender) and We Association (as Escrow Agent) |
| *11.0 | Statement re: Computation of Earnings per Share |
| *31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-O |
| *31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-O |
| *32.1 | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-O |

*32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-O

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* Filed herewith

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(16,559
)

12,175

58,429

18,819

(1,808
)

(8,851
)
General and administrative expense
8,534

8,504

8,373

9,101

8,272

8,021

8,005

8,694

Depreciation and amortization expense
42,437

42,061

40,130

39,573

37,324

35,873

34,823

34,452

Other expenses [1]
2,087

1,855

1,939

1,968

2,522

1,922

2,204

1,979

Straight-line rent revenue
(682

)

(802
)

(1,074
)

(1,722
)

(1,205
)

(1,332
)

(1,783
)

(1,751
)
Other revenue [2]
(1,409
)

(1,173
)

(1,268
)

(1,438
)

(1,258
)

(1,327
)

(1,196
)

(785
)
Cash NOI

$70,131

$69,128

$69,270

$68,837

$66,933

$65,149

$65,469

$65,583

Acquisitions / development completions
(5,583
)

(5,411
)

(4,623

)

(4,273
)

(2,148
)

(956
)

(365
)

(56
)
Reposition
(171
)

(301
)

(353
)

(436
)

(525
)

(584
)

(661
)

(705
)
Dispositions / other
(590
)

(517
)

(1,565
)

(2,719

)

(2,706
)

(2,712
)

(3,330
)

(4,729
)
Same store cash NOI

$63,787

$62,899

$62,729

$61,409

$61,554

$60,897

$61,113

$60,093

(1) Includes acquisition and development expense, bad debt, above and below market ground lease intangible amortization, leasing commission amortization, and ground lease straight-line rent.
(2) Includes management fee income, interest, above and below market lease intangible amortization, lease inducement amortization, lease terminations and tenant improvement overage amortization.
TRAILING TWELVE MONTHS NOI

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2018 | 2017 | % Change |
| Same store cash NOI | $250,824 | $243,657 | 2.9 % |
| Reposition | 1,261 | 2,475 | (49.1 %) |
| Subtotal | $252,085 | $246,132 | 2.4 % |
| Acquisitions / Development completions | 19,890 | 3,525 | 464.3 % |
| Dispositions / other | 5,391 | 13,477 | (60.0 %) |
| Cash NOI | $277,366 | $263,134 | 5.4 % |

EBITDA

| | Q4 2018 | Q3 2018 | Q2 2018 | Q1 2018 | Trailing Twelve Months |
|---|---|---|---|---|---|
| Net income | $16,314 | $6,548 | $37,729 | $9,180 | $69,771 |
| Interest expense | 13,602 | 13,464 | 13,069 | 12,668 | 52,803 |
| Depreciation and amortization | 42,437 | 42,061 | 40,130 | 39,573 | 164,201 |
| EBITDA | $72,353 | $62,073 | $90,928 | $61,421 | $286,775 |
| Acquisition and development expense | 200 | 141 | 120 | 277 | 738 |
| Gain on sales of real estate properties | (10,787 ) | (1,288 ) | (29,590 ) | — | (41,665 ) |
| Debt Covenant EBITDA | $61,766 | $60,926 | $61,458 | $61,698 | $245,848 |
| Other amortization expense | 2,170 | 2,089 | 2,018 | 1,817 | 8,094 |
| Timing impact (1) | (349 ) | (50 ) | (249 ) | — | (648 ) |
| Stock based compensation | 2,601 | 2,605 | 2,593 | 2,822 | 10,621 |
| Adjusted EBITDA | $66,188 | $65,570 | $65,820 | $66,337 | $263,915 |

(1) Adjusted to reflect quarterly EBITDA from properties acquired or disposed in the quarter.

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HEALTHCARE REALTY TRUST INCORPORATED
COMMON STOCK PROXY
HEALTHCARE REALTY TRUST INCORPORATED
PROXY FOR ANNUAL MEETING OF SHAREHOLDERS

Important Notice Regarding the Availability of Proxy Materials for the Shareholder Meeting to Be Held on May 14, 2019: The Proxy Statement and the Company's Annual Report to Shareholders for the year ended December 31, 2018 are available at http://www.viewproxy.com/healthcarerealty/2019.

The undersigned hereby appoints B. Douglas Whitman, II and John M. Bryant, Jr., and either of them, as proxies, with full power of substitution and resubstitution, to vote all of the shares of Common Stock which the undersigned is entitled to vote at the annual meeting of shareholders of Healthcare Realty Trust Incorporated, to be held at 3310 West End Avenue, Suite 700, Nashville, Tennessee 37203, on Tuesday, May 14, 2019, at 10:00 a.m. (local time), and at any adjournment thereof.

This proxy is being solicited by the Board of Directors and will be voted as specified. If not otherwise specified, the above named proxies will vote (1) FOR the election of the nine nominees listed below to serve as directors until the 2020 Annual Meeting or until their successors are duly elected and qualified; (2) FOR the ratification of the appointment of BDO USA, LLP as the independent registered public accounting firm for the Company and its subsidiaries for the Company's 2019 fiscal year; (3) FOR the resolution approving the compensation of the Company's Named Executive Officers on a non-binding advisory basis; and (4) in accordance with the recommendations of the Board of Directors on any other matters that may properly come before the meeting. Pursuant to the rules of the New York Stock Exchange, if a shareholder holds shares through an account with a bank, broker or other nominee and does not provide voting instructions in accordance with this Proxy Statement, such shares may not be voted by the nominee for the above items (1) and (3), in each case resulting in a broker non-vote.

1. Election of Directors:

| | For | Withhold | | For | Withhold | | For | Withhold |
|---|---|---|---|---|---|---|---|---|
| 01- David R. Emery | o | o | 02- Todd J. Meredith | o | o | 03- John V. Abbott | o | o |
| | For | Withhold | | For | Withhold | | For | Withhold |
| 04 - Nancy H. Agee | o | o | 05 - Edward H. Braman | o | o | 06- Peter F. Lyle, Sr. | o | o |
| | For | Withhold | | For | Withhold | | For | Withhold |
| 07- John Knox Singleton | o | o | 08- Bruce D. Sullivan | o | o | 09- Christann M. Vasquez | o | o |

2. To ratify the appointment of BDO USA, LLP as the independent registered public accounting firm for the Company and its subsidiaries for the Company's 2019 fiscal year.

o FOR o AGAINST o ABSTAIN

3. To approve, on a non-binding advisory basis, the following resolution:

RESOLVED, that the shareholders of Healthcare Realty Trust Incorporated approve, on a non-binding advisory basis, the compensation of the Named Executive Officers as disclosed pursuant to Item 402 of Regulation S-K in the Company's proxy statement for the 2019 Annual Meeting of Shareholders.

o FOR o AGAINST o ABSTAIN

4. In their discretion, the proxies are authorized to vote upon such other business as may properly come before the meeting or any adjournment thereof.

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MARK HERE
FOR
ADDRESS
CHANGE
AND NOTE
AT LEFT o

MARK HERE
IF YOU PLAN
TO ATTEND
THE
MEETING o

Date:
Signature:

IMPORTANT
Please sign exactly as your name or names appear on this proxy and mail promptly in the enclosed envelope. If you sign as agent or in any other capacity, please state the capacity in which you sign.

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