VSE CORP
Form 10-Q
October 27, 2017
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 September 30, 2017 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.)

6348 Walker Lane

Alexandria, Virginia	22310	www.vsecorp.com
(Address of Principal Executive Offices)	(Zip Code)	(Webpage)

Registrant's Telephone Number, Including Area Code: (703) 960-4600

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

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.05 per share	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 (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [x] No [ ]

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (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 [ ]
	Emerging growth company [ ]

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transaction period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.
Yes [ ]   No [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes [ ]   No [x]

Number of shares of Common Stock outstanding as of October 20, 2017: 10,838,435

TABLE OF CONTENTS

Table of Contents

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 results of VSE Corporation ("VSE," the "Company," "us," "our," or "we") 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, 2016 filed with the Securities and Exchange Commission ("SEC") on March 1, 2017 ("2016 Form 10-K").

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 2016 Form 10-K 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 and any Current Reports on Form 8-K that we have filed or will file with the SEC subsequent to our 2016 Form 10-K.

Table of Contents

PART I. Financial Information

Item 1. Financial Statements

VSE Corporation and Subsidiaries

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

	September 30, 2017	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	$ 472	$ 428
Receivables, net	72,874	101,218
Inventories, net	135,525	136,340
Other current assets	24,376	20,477
Total current assets	233,247	258,463
Property and equipment, net	56,857	62,061
Intangible assets, net	114,913	126,926
Goodwill	198,622	198,622
Other assets	15,405	15,767
Total assets	$ 619,044	$ 661,839
Liabilities and Stockholders' equity		
Current liabilities:		
Current portion of long-term debt	$ 25,710	$ 21,023
Accounts payable	48,560	93,999
Accrued expenses and other current liabilities	47,852	32,772
Dividends payable	—	648
Total current liabilities	122,122	148,442
Long-term debt, less current portion	155,083	193,621
Deferred compensation	15,749	12,751
Long-term lease obligations, less current portion	20,917	21,959
Deferred tax liabilities	27,981	29,872
Total liabilities	341,852	406,645
Commitments and contingencies		
Stockholders' equity:		
Common stock, par value $0.05 per share, authorized 15,000,000 shares; issued and outstanding 10,838,435 and 10,798,927, respectively	542	540
Additional paid-in capital	24,455	22,876
Retained earnings	252,061	231,733
Accumulated other comprehensive income	134	45
Total stockholders' equity	277,192	255,194
Total liabilities and stockholders' equity	$ 619,044	$ 661,839

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

Table of Contents

VSE Corporation and Subsidiaries

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

	For the three months ended September 30,		For the nine months ended September 30,	
	2017	2016	2017	2016
Revenues:				
Products	$82,314	$ 87,060	$260,585	$ 254,325
Services	91,850	85,720	304,733	222,564
Total revenues	174,164	172,780	565,318	476,889
Costs and operating expenses:				
Products	68,678	70,884	217,606	207,001
Services	88,989	83,599	293,083	215,409
Selling, general and administrative expenses	255	652	1,178	4,173
Amortization of intangible assets	4,005	4,022	12,013	12,063
Total costs and operating expenses	161,927	159,157	523,880	438,646
Operating income	12,237	13,623	41,438	38,243
Interest expense, net	2,347	2,509	7,158	7,406
Income before income taxes	9,890	11,114	34,280	30,837
Provision for income taxes	3,251	4,026	12,541	11,228
Net income	$6,639	$ 7,088	$21,739	$ 19,609
Basic earnings per share	$0.61	$ 0.66	$2.01	$ 1.82
Basic weighted average shares outstanding	10,838,435	10,798,684	10,833,237	10,792,046
Diluted earnings per share	$0.61	$ 0.65	$2.00	$ 1.81
Diluted weighted average shares outstanding	10,856,675	10,826,007	10,855,983	10,819,697
Dividends declared per share	$—	$ —	$0.130	$ 0.115

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

Table of Contents

VSE Corporation and Subsidiaries

Unaudited Consolidated Statements of Comprehensive Income
(in thousands)

	For the three months ended September 30,		For the nine months ended September 30,	
	2017	2016	2017	2016
Net income	$6,639	$7,088	$21,739	$19,609
Change in fair value of interest rate swap agreements	20	337	89	(235)
Other comprehensive (loss) income, net of tax	20	337	89	(235)
Comprehensive income	$6,659	$7,425	$21,828	$19,374

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

Table of Contents

VSE Corporation and Subsidiaries

Unaudited Consolidated Statements of Cash Flows
(in thousands)

	For the nine months ended September 30,	
	2017	2016
Cash flows from operating activities:		
Net income	$21,739	$19,609
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	19,584	19,515
Deferred taxes	(1,947)	(3,047)
Stock-based compensation	1,935	1,747
Earn-out obligation adjustment	—	(1,329)
Changes in operating assets and liabilities:		
Receivables, net	28,344	(7,636)
Inventories, net	815	(19,812)
Other current assets and noncurrent assets	(3,392)	(8,015)
Accounts payable and deferred compensation	(42,441)	19,651
Accrued expenses and other current liabilities	15,916	8,639
Long-term lease obligations	(1,042)	(930)
Net cash provided by operating activities	39,511	28,392
Cash flows from investing activities:		
Purchases of property and equipment	(2,387)	(5,438)
Proceeds from the sale of property and equipment	689	74
Cash paid for acquisitions, net of cash acquired	—	(63)
Net cash used in investing activities	(1,698)	(5,427)
Cash flows from financing activities:		
Borrowings on loan agreement	258,657	231,139
Repayments on loan agreement	(292,913)	(232,608)
Earn-out obligation payments	—	(18,515)
Payments on capital lease obligations	(954)	(835)
Payments of taxes for equity transactions	(500)	(499)
Dividends paid	(2,059)	(1,834)
Net cash used in financing activities	(37,769)	(23,152)
Net increase (decrease) in cash and cash equivalents	44	(187)
Cash and cash equivalents at beginning of period	428	740
Cash and cash equivalents at end of period	$472	$553

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

Table of Contents

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2017

(1) Nature of Business and Basis of Presentation

Our accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and the instructions to SEC Form 10-Q and Article 10 of SEC Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles 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 and nine months ended September 30, 2017 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2017. For further information refer to the consolidated financial statements and footnotes thereto included in our 2016 Form 10-K.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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, recoverability of goodwill and intangible assets, and earn-out obligations.

Recently Adopted Accounting Pronouncements

Effective January 1, 2017, we adopted the Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which is intended to simplify the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities and classification on the statement of cash flows. We have elected to account for forfeitures as they occur. The adoption of ASU 2016-09 did not have a significant impact on our consolidated financial position, results of operations or cash flows.

Effective January 1, 2017, we adopted ASU No. 2015-11, Simplifying the Measurement of Inventory, which clarifies that, for inventories measured at the lower of cost and net realizable value, net realizable value should be determined based on the estimated selling prices in the ordinary course of business less reasonably predictable costs of completion, disposal, and transportation. The adoption of ASU 2015-11 did not have a significant impact on our consolidated financial position, results of operations or cash flows.

In January 2017, the FASB issued ASU No. 2017-04, Simplifying the Test for Goodwill Impairment, which eliminates the requirement to determine the fair value of individual assets and liabilities of a reporting unit to measure goodwill impairment. Under the amendments in ASU 2017-04, goodwill impairment testing will be performed by comparing the fair value of the reporting unit with its carrying amount and recognizing an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value. The new standard is effective for annual and interim goodwill impairment tests in fiscal years beginning after December 15, 2019, and should be applied on a prospective basis with early adoption permitted. We elected to early adopt ASU 2017-04 effective April 1, 2017 and will apply the new standard to our 2017 annual goodwill impairment test, as well as any interim tests. The adoption is not expected to have a significant impact on our consolidated financial position, results of operations or cash flows.

Stock Split Effected in Form of Stock Dividend

In May 2016, our Board of Directors approved a two-for-one stock split effected in the form of a stock dividend ("Stock Split"). The Stock Split had a record date of July 20, 2016 and the stock distribution occurred on August 3, 2016. All references made to share or per share amounts in the accompanying unaudited consolidated financial statements and disclosures have been retroactively adjusted to reflect the Stock Split.

(2) Debt

We have a loan agreement with a group of banks that was amended in January 2015 to fund our Aviation Acquisition and provide working capital for our continuing operations. The loan agreement, which expires in January 2020, is comprised of a term loan facility and a revolving loan facility. The revolving loan facility provides for revolving loans and letters of credit.

Our required term loan payments after September 30, 2017 are approximately $5.6 million in 2017, $28.1 million in 2018, $30.0 million in 2019, and $36.3 million in 2020. The amount of term loan borrowings outstanding as of September 30, 2017 was $100.0 million.

The maximum amount of credit available to us under the loan agreement for revolving loans and letters of credit as of September 30, 2017 was $150 million. We may borrow and repay the revolving loan borrowings as our cash flows require or permit. We pay an unused commitment fee and fees on letters of credit that are issued. We had approximately $82.1 million in revolving loan amounts outstanding and no letters of credit outstanding as of September 30, 2017. We had approximately $100.4 million in revolving loan amounts outstanding and no letters of credit outstanding as of December 31, 2016.

Under the loan agreement we may elect to increase the maximum availability of the term loan facility, the revolving loan facility, or both facilities up to an aggregate additional amount of $75 million.

Total bank loan borrowed funds outstanding, including term loan borrowings and revolving loan borrowings, were approximately $182.1 million and $216.3 million, as of September 30, 2017 and December 31, 2016, respectively. These amounts exclude unamortized deferred financing costs of approximately $1.3 million and $1.7 million as of September 30, 2017 and December 31, 2016, respectively, which are being amortized over a five-year period through July 2020. The fair value of outstanding debt as of September 30, 2017 under our bank loan facilities approximates its carrying value using Level 2 inputs based on market data on companies with a corporate rating similar to ours that have recently priced credit facilities.

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. As of September 30, 2017, the LIBOR base margin was 2.00% and the base rate base margin was 0.75%. The base margins increase or decrease in increments as our Total Funded Debt/EBITDA Ratio increases or decreases.

The loan agreement requires us to have interest rate hedges on a portion of the outstanding term loan for the first three years after the January 2015 amendment date of the agreement. We executed interest rate swap agreements in February 2015 that complied with the loan agreement. The notional amount of the interest rate swap agreements as of September 30, 2017 was $85 million.

After taking into account the impact of interest rate swap agreements, as of September 30, 2017, interest rates on portions of our outstanding debt ranged from 3.24% to 5.00%, and the effective interest rate on our aggregate outstanding debt was 3.36%.

Interest expense incurred on bank loan borrowings and interest rate hedges was approximately $1.8 million and $2.0 million for the quarters ended September 30, 2017 and 2016, respectively. Interest expense incurred on bank loan borrowings and interest rate hedges was approximately $5.6 million and $5.8 million for the nine months ended September 30, 2017 and 2016, respectively.

The loan agreement contains collateral requirements to secure our borrowings and other loan agreement obligations, restrictive covenants, a limit on annual dividends, and other affirmative and negative covenants, 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 terms and conditions at September 30, 2017.

(3) Earnings Per Share

Basic earnings per share ("EPS") has 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 an assumed vesting of restricted stock awards.

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Basic weighted average common shares outstanding	10,838,435	10,798,684	10,833,237	10,792,046
Effect of dilutive shares	18,240	27,323	22,746	27,651
Diluted weighted average common shares outstanding	10,856,675	10,826,007	10,855,983	10,819,697

-9-

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2017

(4) Commitments and Contingencies

Contingencies

Hawaii Litigation

In 2012, the estates of five deceased individuals and their relatives filed complaints in a state court in Hawaii against VSE and other entities and individuals for unspecified damages, alleging that the explosion of fireworks and diesel fuel that killed the five individuals in April 2011 was caused by negligence of VSE and the other defendants. The five deceased plaintiffs were employees of a vendor retained by VSE to dispose of fireworks and other explosives seized by the federal government. In September 2017, VSE together with its insurance carriers, agreed in principle with all of the plaintiffs to settle this litigation. The settlement documents are being finalized and the settlement will be fully funded by VSE’s insurers, resulting in no material adverse effect on our results of operations, financial condition, or cash flows. We have recorded as of September 30, 2017 a liability for our estimated amount of the settlement and a related receivable from our insurers for our estimated recovery, which we believe is probable of recovery based on our evaluation of insurance coverage and the insurers’ agreement and ability to fully fund the settlement.

Aviation Litigation

In November 2016, a lawsuit, Arrieta et al vs. Prime Turbines LLC et al, was filed in the District Court of Texas in Dallas County, by Edgar Arrieta, and four other plaintiffs against VSE subsidiaries, Kansas Aviation of Independence, L.L.C. and Prime Turbines LLC, and three other unrelated defendants. The other named defendants are Pratt & Whitney of Canada Corporation, Cessna Aircraft Company and Woodward Inc. The plaintiffs allege that on April 1, 2016, a plane crashed resulting in the death of three plaintiffs and serious injuries to six other plaintiffs and that VSE's subsidiaries were negligent in providing maintenance, service and inspection of the airplane engine prior to the crash. Plaintiffs are seeking monetary relief over $1.0 million from the defendants. Trial is scheduled for May 2018. VSE together with its insurance carrier, will aggressively defend the proceedings. While the results of legal proceedings cannot be predicted with certainty and the amount of loss, if any, cannot be reasonably estimated, we do not anticipate that this lawsuit will have a material adverse effect on our results of operation, financial condition, or cash flows.

Other Matters

In addition to the above-referenced legal proceedings, we may have certain claims in the normal course of business, including legal proceedings, against us and against other parties. In our opinion, the resolution of these other claims will not have a material adverse effect on our results of operations, financial position, or cash flows. However, because the results of any legal proceedings cannot be predicted with certainty, the amount of loss, if any, cannot be reasonably estimated.

Further, from time-to-time, government agencies investigate whether our operations are being conducted in accordance with applicable contractual and regulatory requirements. Government investigations of us, whether relating to government contracts or conducted for other reasons, could result in administrative, civil or criminal liabilities, including repayments, fines or penalties being imposed upon us, or could lead to suspension or debarment from future government contracting. Government investigations often take years to complete and many result in no adverse action against us. We believe, based upon current information, that the outcome of any such government disputes and investigations will not have a material adverse effect on our results of operations, financial position, or cash flows.

(5) Business Segments and Customer Information

Business Segments

Beginning in 2017, we changed our structure and as a result our former IT, Energy and Management Consulting Group is now combined with our Federal Services Group. Consequently, our segment financial information for 2016 has been restated to reflect such change. Management of our business operations is conducted under three reportable operating segments:

Supply Chain Management Group – Our Supply Chain Management Group supplies vehicle parts primarily through a Managed Inventory Program ("MIP") and direct sales to the United States Postal Service ("USPS") and to other customers.

Table of Contents

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2017

Aviation Group – Our Aviation Group provides maintenance, repair and overhaul ("MRO") services, parts supply and distribution, and supply chain solutions for general aviation jet aircraft engines and engine accessories.

Federal Services Group – Our Federal Services Group provides engineering, industrial, logistics, foreign military sales, legacy equipment sustainment services, IT and technical and consulting services primarily to the United States Department of Defense ("DoD") and other government agencies.

The operating segments reported below are the segments of the Company for which separate financial information is available and for which segment results are evaluated regularly by our Chief Executive Officer in deciding how to allocate resources and in assessing performance. We evaluate segment performance based on consolidated revenues and operating income. Net sales of our business segments exclude intersegment sales as these activities are eliminated in consolidation.

Our segment information for the three and nine months ended September 30, 2017 and 2016 is as follows (in thousands):

	Three months		Nine months	
	2017	2016	2017	2016
Revenues:				
Supply Chain Management Group	$51,174	$51,152	$163,663	$152,080
Aviation Group	31,059	34,688	96,003	100,298
Federal Services Group	91,931	86,940	305,652	224,511
Total revenues	$174,164	$172,780	$565,318	$476,889
Operating income:				
Supply Chain Management Group	$8,178	$8,749	$25,611	$26,600
Aviation Group	1,983	3,950	6,898	9,896
Federal Services Group	2,593	1,650	10,503	5,041
Corporate/unallocated expenses	(517)	(726)	(1,574)	(3,294)
Operating income	$12,237	$13,623	$41,438	$38,243

Table of Contents

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2017

Customer Information

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

	Three months ended September 30,				Nine months ended September 30,			
Customer	2017	%	2016	%	2017	%	2016	%
U.S. Postal Service	$43,833	25.2%	$44,433	25.7%	$136,261	24.1%	$135,025	28.3%
U.S. Navy	38,895	22.3%	43,424	25.1%	143,421	25.4%	109,884	23.0%
U.S. Army	45,717	26.3%	40,155	23.3%	150,217	26.6%	96,656	20.2%
U.S. Air Force	2,967	1.7 %	757	0.4 %	5,807	1.0 %	2,614	0.6 %
Total - DoD	87,579	50.3%	84,336	48.8%	299,445	53.0%	209,154	43.8%
Commercial aviation	30,637	17.6%	32,489	18.8%	94,706	16.8%	98,099	20.6%
Other commercial	2,833	1.6 %	2,720	1.6 %	9,270	1.6 %	7,807	1.6 %
Total - Commercial	33,470	19.2%	35,209	20.4%	103,976	18.4%	105,906	22.2%
Other civilian agencies	9,282	5.3 %	8,802	5.1 %	25,636	4.5 %	26,804	5.7 %
Total	$174,164	100 %	$172,780	100 %	$565,318	100 %	$476,889	100 %

(6) Goodwill and Intangible Assets

Changes in goodwill for the nine months ended September 30, 2017 are as follows (in thousands):

	Supply Chain Management	Federal Services	Aviation	Total
Balance as of December 31, 2016	$ 63,190	$30,883	$104,549	$198,622
Balance as of September 30, 2017	$ 63,190	$30,883	$104,549	$198,622

Intangible assets consist of the value of contract and customer-related intangible assets, acquired technologies and trade names. Amortization expense was approximately $4.0 million and $12.0 million for the three and nine months ended September 30, 2017 and approximately $4.0 million and $12.1 million for the three and nine months ended September 30, 2016, respectively.

Table of Contents

VSE CORPORATION AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2017

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

	Cost	Accumulated Amortization	Accumulated Impairment Loss	Net Intangible Assets
September 30, 2017				
Contract and customer-related	$173,094	$ (69,653)	$ (1,025)	$ 102,416
Acquired technologies	12,400	(7,124)	—	5,276
Trade names	16,670	(9,449)	—	7,221
Total	$202,164	$ (86,226)	$ (1,025)	$ 114,913
December 31, 2016				
Contract and customer-related	$173,094	$ (59,799)	$ (1,025)	$ 112,270
Acquired technologies	12,400	(6,278)	—	6,122
Trade names	16,670	(8,136)	—	8,534
Total	$202,164	$ (74,213)		