HEALTHCARE SERVICES GROUP INC
Form 10-Q
April 23, 2007

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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 Quarter Ended March 31, 2007 **Commission File Number 0-120152**

HEALTHCARE SERVICES GROUP, INC.
(Exact name of registrant as specified in its charter)

Pennsylvania	23-2018365
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification number)
3220 Tillman Drive-Suite 300, Bensalem, Pennsylvania	19020
(Address of principal executive office)	(Zip code)

Registrant s telephone number, including area code: 215-639-4274

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 Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such returns), (2) has been subject to such filing requirements for the past 90 days. YES þ NO o

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 o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES o NO þ

Number of shares of common stock, issued and outstanding as of April 20, 2007 is 27,725,000

Total of 36 Pages

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Certification of Principal Executive Officer
Certification of Principal Financial Officer
Certification of Principal Executive Officer pursuant to Section 906
Certification of Principal Financial Officer pursuant to Section 906

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PART I. FINANCIAL INFORMATION
Item 1. FINANCIAL STATEMENTS

Consolidated Balance Sheets

	(Unaudited) March 31, 2007	December 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 78,999,000	$ 72,997,000
Accounts and notes receivable, less allowance for doubtful accounts of $4,612,000 in 2007 and $2,716,000 in 2006	80,691,000	78,086,000
Inventories and supplies	13,162,000	12,640,000
Deferred income taxes	1,204,000	652,000
Prepaid expenses and other	4,192,000	3,862,000
Total current assets	178,248,000	168,237,000
PROPERTY AND EQUIPMENT:		
Laundry and linen equipment installations	1,748,000	1,781,000
Housekeeping equipment and office equipment	16,223,000	16,086,000
Autos and trucks	85,000	85,000
	18,056,000	17,952,000
Less accumulated depreciation	13,308,000	13,077,000
	4,748,000	4,875,000
GOODWILL, Less accumulated amortization of $1,743,000 in 2007 and 2006	14,570,000	14,543,000
OTHER INTANGIBLE ASSETS, Less accumulated amortization of $617,000 in 2007 and $352,000 in 2006	6,883,000	7,148,000
NOTES RECEIVABLE- long term portion, net of discount	8,082,000	7,861,000
DEFERRED COMPENSATION FUNDING	8,356,000	7,385,000
DEFERRED INCOME TAXES- long term portion	5,739,000	5,403,000
OTHER NONCURRENT ASSETS	105,000	104,000
TOTAL ASSETS	$ 226,731,000	$ 215,556,000
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 7,474,000	$ 10,139,000
Accrued payroll, accrued and withheld payroll taxes	15,594,000	10,125,000
Other accrued expenses	2,171,000	2,425,000
Income taxes payable	192,000	274,000
Accrued insurance claims	4,623,000	4,647,000
Total current liabilities	30,054,000	27,610,000
ACCRUED INSURANCE CLAIMS- long term portion	10,786,000	10,843,000
DEFERRED COMPENSATION LIABILITY	12,497,000	11,626,000

COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY:		
Common stock, $.01 par value: 30,000,000 shares authorized, 29,172,000 shares issued in 2007 and 28,999,000 shares in 2006	292,000	290,000
Additional paid in capital	62,565,000	58,809,000
Retained earnings	127,831,000	124,268,000
Common stock in treasury, at cost, 1,458,000 shares in 2007 and 1,517,000 shares in 2006	(17,294,000)	(17,890,000)
Total stockholders equity	173,394,000	165,477,000
TOTAL LIABILITITIES AND STOCKHOLDERS EQUITY	$ 226,731,000	$ 215,556,000

See accompanying notes.

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Consolidated Statements of Income
(Unaudited)

	For the Three Months Ended March 31,	
	2007	**2006**
Revenues	$ 140,679,000	$ 118,918,000
Operating costs and expenses:		
Costs of services provided	119,314,000	102,182,000
Selling, general and administrative	10,511,000	9,074,000
Other Income :		
Investment and interest income	1,261,000	1,347,000
Income before income taxes	12,115,000	9,009,000
Income taxes	4,665,000	3,333,000
Net Income	$ 7,450,000	$ 5,676,000
Basic earnings per common share	$ 0.27	$ 0.21
Diluted earnings per common share	$ 0.26	$ 0.20
Cash dividends per common share	$ 0.14	$ 0.10
Basic weighted average number of common shares outstanding	27,771,000	27,320,000
Diluted weighted average number of common shares outstanding	29,108,000	28,620,000

See accompanying notes.

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Consolidated Statements of Cash Flows

	(Unaudited) For the Three Months Ended March 31, 2007	2006
Cash flows from operating activities:		
Net Income	$ 7,450,000	$ 5,676,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	745,000	473,000
Bad debt provision	1,977,000	375,000
Deferred income taxes benefits	(888,000)	(386,000)
Stock-based compensation expense	103,000	81,000
Tax benefit of stock option transactions		513,000
Unrealized gain on deferred compensation fund investments	(382,000)	(434,000)
Changes in operating assets and liabilities:		
Accounts and notes receivable	(4,582,000)	(3,955,000)
Inventories and supplies	(522,000)	(220,000)
Notes receivable- long term portion	(221,000)	226,000
Deferred compensation funding	(589,000)	(91,000)
Accounts payable and other accrued expenses	(2,541,000)	416,000
Accrued payroll, accrued and withheld payroll taxes	6,242,000	5,493,000
Accrued insurance claims	(81,000)	135,000
Deferred compensation liability	871,000	885,000
Income taxes payable	(82,000)	434,000
Prepaid expenses and other assets	(330,000)	(613,000)
Net cash provided by operating activities	7,170,000	9,008,000
Cash flows from investing activities:		
Disposals of fixed assets	61,000	32,000
Additions to property and equipment	(415,000)	
Cash paid for acquisition	(27,000)	(487,000)
Net cash used in investing activities	(381,000)	(455,000)
Cash flows from financing activities:		
Treasury stock transactions in benefit plans	82,000	(37,000)
Dividends paid	(3,887,000)	(2,730,000)
Reissuance of treasury stock pursuant to Dividend Reinvestment Plan	14,000	9,000
Tax benefit from equity compensation plans	1,307,000	
Proceeds from the exercise of stock options	1,697,000	1,209,000
Net cash used in financing activities	(787,000)	(1,549,000)
Net increase in cash and cash equivalents	6,002,000	7,004,000

Cash and cash equivalents at beginning of the period	72,997,000	91,005,000
Cash and cash equivalents at end of the period	$ 78,999,000	$ 98,009,000
Supplementary Cash Flow Information:		
Income taxes cash payments, net of refunds	$ 4,328,000	$ 2,771,000
Issuance of 43,000 shares of Common Stock in 2007 and 64,000 shares of Common Stock in 2006 pursuant to Employee Stock Plans	$ 1,254,000	$ 728,000

See accompanying notes.

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Consolidated Statements of Stockholders Equity
(Unaudited)

For the Three Months Ended March 31, 2007

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Stockholders' Equity
Balance, December 31, 2006	28,999,000	$ 290,000	$ 58,809,000	$ 124,268,000	($17,890,000)	$ 165,477,000
Net income for the period				7,450,000		7,450,000
Exercise of stock options and other share-based compensation, net of 4,000 shares tendered for payment	173,000	2,000	1,695,000			1,697,000
Tax benefit arising from stock option transactions			1,307,000			1,307,000
Shares purchased and shares sold in employee Deferred Compensation Plan and other benefit plans (15,000 shares)					82,000	82,000
Shares issued pursuant to Employee Stock Plans (43,000 shares)			745,000		509,000	1,254,000
Cash dividends $.14 per common share				(3,887,000)		(3,887,000)
Shares issued pursuant to Dividend Reinvestment Plan (1,000 shares)			9,000		5,000	14,000
Balance, March 31, 2007	29,172,000	$ 292,000	$ 62,565,000	$ 127,831,000	($17,294,000)	$ 173,394,000

See accompanying notes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 - Basis of Reporting

The accompanying financial statements are unaudited and do not include certain information and note disclosures required by accounting principles generally accepted in the United States for complete financial statements. However, in our opinion, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The balance sheet shown in this report as of December 31, 2006 has been derived from, and does not include, all the disclosures contained in the financial statements for the year ended December 31, 2006. The financial statements should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006. The results of operations for the quarter ended March 31, 2007 are not necessarily indicative of the results that may be expected for the full fiscal year.

Inventories and supplies include housekeeping, linen and laundry supplies, as well as food provisions. Inventories and supplies are stated at cost to approximate a first-in, first-out (FIFO) basis. Linen supplies are amortized over a 24 month period.

Note 2 - Acquisition

On September 18, 2006, effective as of August 31, 2006, our wholly-owned subsidiary HCSG Merger, Inc acquired 100% of the common stock of Summit Services Group, Inc (Summit) in a transaction accounted for under the purchase method of accounting. Summit is a provider of professional housekeeping, laundry and food services to long-term care and related facilities. In conjunction with the acquisition, the aggregate consideration to the Summit shareholders was comprised of a cash payment of approximately $9,460,000 and the issuing of approximately 369,000 shares of our common stock to such selling shareholders of Summit (valued at approximately $8,516,000). Additionally as of March 31, 2007, we have incurred total transactions costs of approximately $303,000 (including $27,000 in the 2007 first quarter), consisting primarily of accounting and legal fees.

As noted, the Summit acquisition is being accounted for under the purchase method of accounting. The acquisition was not considered a material transaction. Accordingly, supplemental pro forma information reflecting the acquisition of Summit as if it occurred on January 1, 2006 has not been provided. Furthermore, our results of operations at March 31, 2006 included in this report do not include Summit s operations . Additionally, effective January 1, 2007, Summit s operations were fully integrated into our operations.

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Note 3 - Goodwill and Other Intangible Assets

We apply the provisions of SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets in accounting for our goodwill and other identifiable intangible assets. SFAS No. 141 addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination, whether acquired individually or with a group of other assets, and the accounting and reporting for goodwill and other intangible assets subsequent to their acquisition.

The following table sets forth the amounts of our identifiable intangible assets subject to amortization, which were acquired in the Summit acquisition, and the amortization expense recognized thereon for the 2007 first quarter:

	Acquisition Amount	Amortization Expense
Customer Relationships	$ 6,700,000	$ 239,000
Non-compete Agreements	800,000	25,000
Total	$ 7,500,000	$ 264,000

The customer relationships have a weighted-average amortization period of seven years and the non-compete agreements have a weighted-average amortization period of eight years. The following table sets forth the estimated amortization expense for intangibles subject to amortization for the remaining nine months in our 2007 fiscal year and following four fiscal years:

Period/Year	Customer Relationships	Non-Compete Agreements	Total
April 1 to December 31, 2007	$718,000	$ 75,000	$ 793,000
2008	$957,000	$100,000	$1,057,000
2009	$957,000	$100,000	$1,057,000
2010	$957,000	$100,000	$1,057,000
2011	$957,000	$100,000	$1,057,000

The following table sets forth the amount of goodwill as March 31, 2007 which is subject to impairment testing, rather than amortization and the adjustments, if any, to the amounts of such goodwill during the three months ended March 31, 2007.

	Summit	All other	Total
Goodwill as of December 31, 2006	$ 12,931,000	$ 1,612,000	$ 14,543,000
Goodwill adjustments during first quarter(1)	27,000		27,000
Goodwill as of March 31, 2007	$ 12,958,000	$ 1,612,000	$ 14,570,000

(1) Goodwill adjusted during the quarter relates to professional fees expense incurred.

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The following table sets forth by reportable business segment, as described in Note 5 herein, the amounts of goodwill:

Segment	Amount
Food	$ 1,351,000
Housekeeping	13,219,000
Total	$ 14,570,000

Note 4- Other Contingencies

We have a $30,000,000 bank line of credit on which we may draw to meet short-term liquidity requirements in excess of internally generated cash flow. Amounts drawn under the line of credit are payable upon demand. At March 31, 2007, there were no borrowings under the line of credit. However, at such date, we had outstanding a $27,725,000 irrevocable standby letter of credit which relates to payment obligations under our insurance programs. As a result of the letters of credit issued, the amount available under the line of credit was reduced by $27,725,000 at March 31, 2007. The line of credit requires us to satisfy two financial covenants. We are in compliance with the financial covenants at March 31, 2007 and expect to continue to remain in compliance with such financial covenants. This line of credit expires on June 30, 2007. We believe the line of credit will be renewed at that time.

We provide our services in 47 states and we are subject to numerous local taxing jurisdictions within those states. Consequently, the taxability of our services is subject to various interpretations within these jurisdictions. In the ordinary course of business, a jurisdiction may contest our reporting positions with respect to the application of its tax code to our services, which may result in additional tax liabilities.

At both March 31, 2007 and December 31, 2006 we had unsettled tax assessments from a state taxing authority of $580,000 ($363,000, net of federal income taxes). With respect to these assessments, we recorded a reserve at both March 31, 2007 and December 31, 2006 of $320,000 ($175,000 net of federal income taxes).

In other tax matters, because of the uncertainties related to both the probable outcome and amount of probable assessment due, we are unable to make a reasonable estimate of a liability. We do not expect the resolution of any of these matters, taken individually or in the aggregate, to have a material adverse affect on our consolidated financial position or results of operations based on our best estimate of the outcomes of such matters.

We are involved in miscellaneous claims and litigation arising in the ordinary course of business. We believe that these matters, taken individually or in the aggregate, would not have a material adverse affect on our financial position or consolidated results of operations.

Congress has enacted a number of major laws during the past decade that have significantly altered, or threaten to alter, overall government reimbursement for nursing home services. Because our clients revenues are generally highly reliant on Medicare and Medicaid reimbursement funding rates and mechanisms, the overall effect of these laws and trends in the long term care industry have affected and could adversely affect the liquidity of our clients, resulting in their inability to make payments to us on agreed upon payment terms. These factors in addition to delays in payments from clients, have resulted in and could continue to result in significant additional bad debts in the near future

Note 5- Segment Information

Reportable Operating Segments

We manage and evaluate our operations in two reportable segments. The two reportable segments are Housekeeping (housekeeping, laundry, linen and other services), and Food (food services). Although both segments serve the same client base and share many operational similarities, they are managed separately due to distinct differences in the type of service provided, as well as the specialized expertise required of the professional management personnel responsible for delivering the respective segment s services. We consider the various services provided within Housekeeping to be one reportable operating segment since such services are rendered pursuant to a single service agreement and the delivery of such services is managed by the same management personnel.

Differences between the reportable segments operating results and other disclosed data and our consolidated financial statements relate primarily to corporate level transactions, as well as transactions between reportable segments and our warehousing and distribution subsidiary. The subsidiary s transactions with reportable segments are made on a basis intended to reflect the fair market value of the goods transferred. Additionally, included in the differences between the reportable segments operating results and other disclosed data are amounts attributable to our investment holding company subsidiary. This subsidiary does not transact any business with the reportable segments. Segment amounts reported are prior to any elimination entries made in consolidation.

Housekeeping provides services in Canada, although essentially all of its revenues and net income, 99% in both categories, are earned in one geographic area, the United States. Food provides services solely in the United States.

	Housekeeping	Food	Corporate and Eliminations	Total
Quarter Ended March 31, 2007				
Revenues	$113,201,000	$26,553,000	$ 925,000	$140,679,000
Income before income taxes	$ 11,320,000	$ 1,181,000	$ (386,000)(1)	$ 12,115,000
Quarter Ended March 31, 2006				
Revenues	$ 94,859,000	$23,039,000	$ 1,020,000	$118,918,000
Income before income taxes	$ 9,414,000	$ 703,000	$(1,108,000)(1)	$ 9,009,000

(1) represents primarily corporate office cost and related overhead, as well as consolidated subsidiaries operating expenses that are not allocated to the reportable segments.

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Total Revenues from Clients

The following revenues earned from clients differ from segment revenues reported above due to the inclusion of adjustments used for segment reporting purposes by management. We earned total revenues from clients in the following service categories:

	For the Quarter Ended March 31, 2007	2006
Housekeeping services	$ 79,529,000	$ 67,307,000
Laundry and linen services	34,212,000	28,091,000
Food Services	26,319,000	22,909,000
Maintenance services and Other	619,000	611,000
	$ 140,679,000	$ 118,918,000

Major Client

We have one client, a nursing home chain, which in the three month periods ended March 31, 2007 and 2006 accounted for 16% and 19%, respectively, of total revenues. In the three month period ended March 31, 2007, we derived 15% and 22%, respectively, of Housekeeping and Food s revenues from such client. Additionally, at both March 31, 2007 and December 31, 2006, amounts due from such client represented less than 1% of our accounts receivable balance. This client completed its previously announced merger on March 14, 2006. Our relationship with the successor entity remains under the same terms and conditions as established prior to the merger**.** Although we expect to continue the relationship with this client, there can be no assurance thereof. The loss of such client, or a significant reduction in revenues from such client, would have a material adverse effect on the results of operations of our two operating segments. In addition, if such client changes its payment terms it would increase our accounts receivable balance and have a material adverse effect on our cash flows and cash and cash equivalents.

Note 6 - Earnings Per Common Share

A reconciliation of the numerator and denominator of basic and diluted earnings per common share is as follows:

	Quarter Ended March 31, 2007 Income (Numerator)	Shares (Denominator)	Per-share Amount
Net income	$ 7,450,000		
Basic earnings per common share	$ 7,450,000	27,771,000	$ .27
Effect of dilutive securities:			
Options		1,337,000	(.01)
Diluted earnings per common share	$ 7,450,000	29,108,000	$ .26

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	Quarter Ended March 31, 2006		
	Income (Numerator)	Shares (Denominator)	Per-share Amount
Net income	$ 5,676,000		
Basic earnings per common share	$ 5,676,000	27,320,000	$ .21
Effect of dilutive securities:			
Options		1,300,000	(.01)
Diluted			