TILE SHOP HOLDINGS, INC.
Form 10-Q
October 27, 2016
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from – to –

Commission file number: 001-35629

TILE SHOP HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Delaware	45-5538095
(State or other jurisdiction of incorporation)	(I.R.S. Employer Identification No.)

14000 Carlson Parkway	
Plymouth, Minnesota	55441
(Address of principal executive offices)	(Zip Code)

(763) 852-2950

(Registrant's telephone number, including area code)

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 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 (§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 No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company

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

As of October 24, 2016, there were 51,593,979 shares of the registrant's common stock, par value $0.0001 per share, outstanding.

TILE SHOP HOLDINGS, INC.

Table of Contents

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Tile Shop Holdings, Inc. and Subsidiaries

Consolidated Balance Sheets

(dollars in thousands, except share and per share data)

(unaudited)

	September 30, 2016	(As Adjusted) December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$ 9,835	$ 10,330
Restricted cash	210	219
Trade receivables, net	2,560	1,966
Inventories	66,379	69,878
Prepaid inventory	415	568
Income tax receivable	1,226	735
Other current assets, net	3,890	3,557
Total Current Assets	84,515	87,253
Property, plant and equipment, net	137,774	135,115
Deferred tax assets	19,781	20,846
Other assets	1,723	1,793
Total Assets	$ 243,793	$ 245,007
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 18,008	$ 14,584
Current portion of long-term debt	5,600	4,744
Income tax payable	404	1,101
Other accrued liabilities	22,764	19,327
Total Current Liabilities	46,776	39,756

Long-term debt, net	18,469	51,178
Capital lease obligation, net	725	797
Deferred rent	37,028	34,983
Other long-term liabilities	3,400	3,092
Total Liabilities	106,398	129,806
Stockholders’ Equity:		
Common stock, par value $0.0001; authorized: 100,000,000 shares; issued and outstanding: 51,575,420 and 51,437,973 shares, respectively	5	5
Preferred stock, par value $0.0001; authorized: 10,000,000 shares; issued and outstanding: 0 shares	-	-
Additional paid-in-capital	184,893	180,192
Accumulated deficit	(47,482)	(64,985)
Accumulated other comprehensive (loss) income	(21)	(11)
Total Stockholders' Equity	137,395	115,201
Total Liabilities and Stockholders' Equity	$ 243,793	$ 245,007

See accompanying Notes to Consolidated Financial Statements.

Table of Contents

Tile Shop Holdings, Inc. and Subsidiaries

Consolidated Statements of Operations

(dollars in thousands, except per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net sales	$ 78,559	$ 72,404	$ 247,543	$ 221,073
Cost of sales	23,400	21,691	73,980	68,096
Gross profit	55,159	50,713	173,563	152,977
Selling, general and administrative expenses	47,361	44,047	142,300	130,678
Income from operations	7,798	6,666	31,263	22,299
Interest expense	(363)	(503)	(1,382)	(2,101)
Other income	34	34	102	97
Income before income taxes	7,469	6,197	29,983	20,295
Provision for income taxes	(2,886)	(2,436)	(11,793)	(8,385)
Net income	$ 4,583	$ 3,761	$ 18,190	$ 11,910
Income per common share:				
Basic	$ 0.09	$ 0.07	$ 0.35	$ 0.23
Diluted	$ 0.09	$ 0.07	$ 0.35	$ 0.23
Weighted average shares outstanding:				
Basic	51,426,104	51,161,348	51,388,058	51,137,650
Diluted	51,929,226	51,424,979	51,817,588	51,254,547

See accompanying Notes to Consolidated Financial Statements.

Table of Contents

Tile Shop Holdings, Inc. and Subsidiaries

Consolidated Statements of Comprehensive (Loss) Income

(dollars in thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$ 4,583	$ 3,761	$ 18,190	$ 11,910
Currency translation adjustment	(2)	(7)	(10)	(6)
Other comprehensive (loss) income	(2)	(7)	(10)	(6)
Comprehensive income	$ 4,581	$ 3,754	$ 18,180	$ 11,904

See accompanying Notes to Consolidated Financial Statements.

Table of Contents

Tile Shop Holdings, Inc. and Subsidiaries

Consolidated Statements of Stockholders' Equity (Deficit)

(dollars in thousands, except share data)

(unaudited)

	Common stock						
	Shares	Amount	Additional paid-in capital	Treasury units	Retained earnings (deficit)	Accumulated other comprehensive income (loss)	Total
Balance at December 31, 2014	51,314,005	$ 5	$ 174,371	$ -	$ (80,681)	$ -	$ 93,695
Issuance of restricted shares	54,036	-	-	-	-	-	-
Stock based compensation	-	-	5,545	-	-	-	5,545
Stock option exercises	69,932	-	276	-	-	-	276
Foreign currency translation adjustments	-	-	-	-	-	(11)	(11)
Net income	-	-	-	-	15,696	-	15,696
Balance at December 31, 2015	51,437,973	$ 5	$ 180,192	$ -	$ (64,985)	$ (11)	$ 115,201
Reclassification of impact of ASU 2016-09 (see Note 1)	-	-	687	-	(687)	-	-
Balance at January 1, 2016	51,437,973	$ 5	$ 180,879	$ -	$ (65,672)	$ (11)	$ 115,201
Issuance of restricted shares	73,384	-	-	-	-	-	-
Stock based compensation	-	-	3,394	-	-	-	3,394
Stock option exercises	64,063	-	620	-	-	-	620
Foreign currency translation adjustments	-	-	-	-	-	(10)	(10)
Net income	-	-	-	-	18,190	-	18,190
Balance at September 30, 2016	51,575,420	$ 5	$ 184,893	$ -	$ (47,482)	$ (21)	$ 137,395

See accompanying Notes to Consolidated Financial Statements.

Table of Contents

Tile Shop Holdings, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(dollars in thousands)

(unaudited)

	Nine Months Ended September 30,	
	2016	2015
Cash Flows From Operating Activities		
Net income	$ 18,190	$ 11,910
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation & amortization	16,954	16,597
Amortization of debt issuance costs	416	238
Debt issuance cost writeoff	-	194
Loss on disposals of property, plant and equipment	420	112
Deferred rent	1,767	2,156
Stock based compensation	3,394	4,226
Deferred income taxes	1,065	954
Changes in operating assets and liabilities:		
Trade receivables	(594)	(536)
Inventories	3,499	5,661
Prepaid expenses and other current assets	(303)	(1,634)
Accounts payable	3,337	1,341
Income tax receivable/payable	(1,188)	7,369
Accrued expenses and other liabilities	3,721	2,793
Net cash provided by operating activities	50,678	51,381
Cash Flows From Investing Activities		
Purchases of property, plant and equipment	(19,645)	(12,196)
Proceeds from the sale of property, plant and equipment	-	9
Net cash used in investing activities	(19,645)	(12,187)
Cash Flows From Financing Activities		
Payments of long-term debt and capital lease obligations	(32,132)	(39,662)
Advances on line of credit	-	10,250
Proceeds from exercise of stock options	620	81
Debt issuance costs	-	(968)
Security deposits	(6)	(5)
Net cash used in financing activities	(31,518)	(30,304)
Effect of exchange rate changes on cash	(10)	(5)

Net change in cash	(495)	8,885
Cash and cash equivalents beginning of period	10,330	5,759
Cash and cash equivalents end of period	$ 9,835	$ 14,644
Supplemental disclosure of cash flow information		
Purchases of property, plant and equipment included in accounts payable and accrued expenses	$ 816	$ 1,370
Cash paid for interest	1,483	2,310
Cash paid for income taxes, net of refunds	12,981	1,016

See accompanying Notes to Consolidated Financial Statements.

7

Table of Contents

Tile Shop Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited)

Note 1: Background

The Tile Shop, LLC (“The Tile Shop”) was formed on December 30, 2002, as a Delaware limited liability company and began operations on January 1, 2003. Tile Shop Holdings, Inc. (“Holdings,” and together with its wholly owned subsidiaries, the “Company”) was incorporated under the laws of the state of Delaware in June 2012 to become the parent company of The Tile Shop, LLC.

The Company is a specialty retailer of manufactured and natural stone tiles, setting and maintenance materials, and related accessories in the United States. The Company manufactures its own setting and maintenance materials, such as thinset, grout, and sealers. The Company’s primary market is retail sales to consumers, contractors, designers and home builders. As of September 30, 2016, the Company had 120 stores in 31 states and an on-line retail operation. The Company also has distribution centers located in Michigan, New Jersey, Oklahoma, Virginia, and Wisconsin. The Company has a sourcing operation located in China.

The accompanying Consolidated Financial Statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the rules and regulations for reporting on Form 10 Q. Accordingly, they do not include certain information and disclosures required for comprehensive financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature, including the elimination of all intercompany transactions. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2016.

These statements should be read in conjunction with the Consolidated Financial Statements and footnotes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. The accounting policies used in preparing these Consolidated Financial Statements are the same as those described in Note 1 to the Consolidated Financial Statements in such Form 10-K. Debt issuance costs presented in the prior year Consolidated Balance Sheet have been reclassified to conform to current year presentation.

Recently Adopted Accounting Pronouncements

In February 2015, the Financial Accounting Standards Board ("FASB") issued a new accounting standard that will modify current consolidation guidance. The standard makes changes to both the variable interest entity model and the voting interest entity model, including modifying the evaluation of whether limited partnerships or similar legal entities are variable interest entities or voting interest entities and amending the guidance for assessing how relationships of related parties affect the consolidation analysis of variable interest entities. The standard was effective for the Company as of the beginning of fiscal 2016. The adoption of this new standard did not have a material effect on the Company's financial statements.

In April 2015, the FASB issued a standard that requires debt issuance costs related to a recognized debt liability be presented in the Consolidated Balance Sheet as a direct deduction from the carrying amount of that debt liability. The Company adopted the provisions of this statement in the first quarter of 2016 and prior periods have been retrospectively adjusted. The adoption of this standard resulted in a $0.1 million reduction of other current assets, net, a $0.3 million reduction of other assets, a $0.3 million reduction of the current portion of long term debt, and a $0.1 million reduction of long term debt in the Consolidated Balance Sheet for the period ended December 31, 2015.

In March 2016, the FASB issued a standard that amends and simplifies the accounting for stock compensation. The guidance addresses various stock compensation aspects including accounting for income taxes, classification of excess tax benefits on the statement of cash flows, forfeitures, minimum statutory tax withholding requirements, and classification of employee taxes paid on the statement of cash flows when an employer withholds shares for tax withholding purposes, among other things. In order to simplify the accounting for stock-based compensation, the Company made a change in accounting policy to account for forfeitures when they occur, and as a result, the Company recognized a $0.7 million cumulative-effect reduction to retained earnings under the modified retrospective approach. During the three months ended September 30, 2016, the Company recognized an adjustment to reduce additional paid-in capital and share-based compensation by $0.1 million to account for current year forfeiture activity.

The Company elected prospective transition for the requirement to classify excess tax benefits as an operating activity in the Consolidated Statement of Cash Flows. The adoption did not have a material impact on the amounts reported in the Consolidated Statement of Cash Flows for the nine months ended September 30, 2016. Additionally, the Company will prospectively recognize all excess tax benefits and tax deficiencies as income tax expense or benefit in the Consolidated Statement of Operations as a discrete item in the period in which awards vest. The adoption did not have a material impact on the amounts reported in the Consolidated Statement of Operations for the three and nine months ended September 30, 2016. The Company applied the modified retrospective method to recognize the cumulative effect of previously unrecognized excess tax benefits in opening retained earnings. The adoption did not have a material impact on the amounts reported in the Consolidated Balance Sheet for the year ended December 31, 2015. The Company

Tile Shop Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited)

also retrospectively applied the requirement to present employee taxes paid when an employer withholds shares for tax-withholding purposes as a financing activity in the Consolidated Statement of Cash Flows. The adoption did not have a material impact on the amounts reported in the Consolidated Statement of Cash Flows for the nine months ended September 30, 2016 and 2015.

Accounting Pronouncements Not Yet Adopted

In May 2014, the FASB issued a final standard on revenue from contracts with customers. The new standard sets forth a single comprehensive model for recognizing and reporting revenue. The new standard is effective for the Company in fiscal year 2018 and permits the use of either a retrospective or a cumulative effect transition method. The Company is currently assessing the impact of implementing the new guidance on its consolidated financial statements.

In August 2014, the FASB issued a standard requiring an entity's management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern within one year after the date of the financial statements. The guidance also sets forth a series of disclosures that are required in the event the entity's management concludes that there is substantial doubt about the entity's ability to continue as a going concern. The new standard becomes effective for the Company in the annual financial statements for fiscal 2016 and requires an ongoing evaluation at each interim and annual period thereafter. The Company is currently assessing the effect the new standard will have on its consolidated financial statements.

In July 2015, the FASB issued a standard which simplifies the subsequent measurement of inventory. Currently, an entity is required to measure inventory at the lower of cost or market, whereby market can be replacement cost, net realizable value, or net realizable value less an approximately normal profit margin. The changes require that inventory be measured at the lower of cost and net realizable value, thereby eliminating the use of the other two market methodologies. Net realizable value is defined as the estimated selling prices in the ordinary course of business less reasonably predictable costs of completion, disposal, and transportation. Currently, the Company applies the net realizable value market option to measure inventories at the lower of cost or market. These changes become effective for the Company in fiscal 2017. The Company is currently assessing the effect the new standard will have on its consolidated financial statements.

In February 2016, the FASB issued a standard that primarily requires organizations that lease assets to recognize the rights and obligations created by those leases on the Consolidated Balance Sheet. The standard is effective in 2019, with early adoption permitted. The Company is currently assessing the effect the new standard will have on its consolidated financial statements.

Note 2: Inventories

Inventories are stated at the lower of cost (determined on the weighted average cost method) or market. Inventories consist primarily of merchandise held for sale. Inventories were comprised of the following as of September 30, 2016 and December 31, 2015:

	(in thousands)	
	September 30, 2016	December 31, 2015
Finished goods	$ 52,896	$ 59,503
Raw materials	2,506	2,681
Finished goods in transit	10,977	7,694
Total	$ 66,379	$ 69,878

The Company records provisions for losses related to shrinkage and other amounts that are otherwise not expected to be fully recoverable. These provisions are calculated based on historical shrinkage, selling price, margin and current business trends.

Note 3: Income taxes

The Company's effective tax rate on net income before income taxes for the three months ended September 30, 2016 and 2015 was 38.6% and 39.3%, respectively. The Company's effective tax rate on net income before income taxes for the nine months ended September 30, 2016 and 2015 was 39.3% and 41.3%, respectively. The improvement in the effective tax rate in 2016 was due to an increase in incentive stock option exercise activity classified as a disqualifying disposition to the option holder that gives rise to a deduction for the Company. The Company's tax rate also benefitted from a decrease in non-deductible incentive stock-based compensation expense in 2016 combined with a reduction in the level of state tax rate changes that triggered unfavorable deferred tax adjustments in 2015. For the three months ended September 30, 2016 and 2015, the Company recorded a provision for income taxes of

9

$2.9 million and $2.4 million, respectively. For the nine months ended September 30, 2016 and 2015, the Company recorded a provision for income taxes of $11.8 million and $8.4 million, respectively.

The Company records interest and penalties relating to uncertain tax positions in income tax expense. As of September 30, 2016 and 2015, the Company has not recognized any liabilities for uncertain tax positions nor have interest and penalties related to uncertain tax positions been accrued.

Note 4: Earnings Per Share

Basic earnings per share is calculated by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is calculated by dividing net income by the weighted-average number of common shares outstanding, after taking into consideration all dilutive potential shares outstanding during the period.

Basic and diluted earnings per share were calculated as follows:

(dollars in thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	2016	2015	2016	2015
Net income	$ 4,583	$ 3,761	$ 18,190	$ 11,910
Weighted average basic shares outstanding	51,426,104	51,161,348	51,388,058	51,137,650
Effect of dilutive securities attributable to stock-based awards	503,122	263,631	429,530	116,897
Weighted average diluted shares outstanding	51,929,226	51,424,979	51,817,588	51,254,547
Income per common share:				
Basic	$ 0.09	$ 0.07	$ 0.35	$ 0.23

Dilutive	$ 0.09	$ 0.07	$ 0.35	$ 0.23
Anti-dilutive securities excluded from earnings per share calculation	347,699	769,778	409,599	1,021,033

Note 5: Other Accrued Liabilities

Other accrued liabilities consisted of the following:

	(in thousands)	
	September 30, 2016	December 31, 2015
Customer deposits	$ 7,565	$ 6,026
Accrued wages and salaries	5,629	4,336
Sales return reserve	3,003	2,781
Taxes (other than income taxes)	3,451	3,043
Other accrued liabilities	3,116	3,141
Total other accrued liabilities	$ 22,764	$ 19,327

Note 6: Long-term Debt

On June 2, 2015, Holdings and its operating subsidiary, The Tile Shop, LLC, as well as certain other subsidiaries of Holdings, entered into a credit agreement with Fifth Third Bank, Bank of America, N.A., and Huntington National Bank (the “Credit Agreement”). The Credit Agreement provides the Company with a $125.0 million senior secured credit facility, comprised of a five-year $50.0 million term loan and a $75.0 million revolving line of credit. The Credit Agreement is secured by virtually all of the assets of the Company, including but not limited to, inventory, receivables, equipment and real property. Borrowings pursuant to the Credit Agreement bear interest at either a base rate or a LIBOR-based rate, at the option of the Company. The LIBOR-based rate will range from LIBOR plus 1.50% to 2.00%, depending on The Tile Shop’s leverage ratio. The base rate is equal to the greatest of: (a) the Federal funds rate plus 0.50%, (b) the Fifth Third Bank “prime rate,” and (c) the Eurodollar rate plus 1.00%, in each case plus 0.50% to 1.00% depending on

Table of Contents

Tile Shop Holdings, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(unaudited)

The Tile Shop's leverage ratio. At September 30, 2016 the base interest rate was 4.00% and the LIBOR-based interest rate was 2.03%. Borrowings outstanding consisted of $23.4 million on the term loan as of September 30, 2016. The Company can elect to prepay the term loan without incurring a penalty. Additional borrowings pursuant to the Credit Agreement may be used to support the Company's growth and for working capital purposes. The Company incurred $1.0 million of debt issuance costs in connection with the Credit Agreement, which will be amortized over the five-year life of the Credit Agreement. Debt issuance costs attributable to the term loan are classified as a reduction of debt in the Consolidated Balance Sheet. Debt issuance costs attributable to the revolving line of credit are classified as assets in the Consolidated Balance Sheet. The term loan requires quarterly principal payments as follows (in thousands):

Period	
December 31, 2016 to June 30, 2017	$ 1,250
September 30, 2017 to June 30, 2018	1,875
September 30, 2018 to March 31, 2020	2,500

The Credit Agreement contains customary events of default, conditions to borrowings, and restrictive covenants, including restrictions on the Company's ability to dispose of assets, make acquisitions, incur additional debt, incur liens, make investments, or enter into transactions with affiliates on other than terms that could be obtained in an arm's length transaction. The Credit Agreement also includes financial and other covenants, including covenants to maintain certain fixed charge coverage ratios and rent adjusted leverage ratios. In addition, except with respect to pro rata payments made by The Tile Shop or other subsidiaries to Holdings or any other equity owner of such entity, the Credit Agreement prohibits the payments of cash dividends. The Company was in compliance with the covenants as of September 30, 2016.

Long-term debt, net of debt issuance costs, consisted of the following at September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
Term note payable - interest at 2.03% and 2.18% at September 30, 2016 and December 31, 2015, respectively		