Heritage-Crystal Clean, Inc.
Form 10-Q
July 25, 2008

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 June 14, 2008

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 001-33987

HERITAGE-CRYSTAL CLEAN, INC.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware<br>State or other jurisdiction of incorporation | 26-0351454<br>(I.R.S. Employer Identification No.) |

2175 Point Boulevard
Suite 375
Elgin, IL 60123
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (847) 836-5670

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 R

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

| | | | |
|---|---|---|---|
| Large accelerated filer | o | Accelerated Filer | o |
| Non-accelerated filer | x | Smaller reporting company | o |

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

Number of shares outstanding of registrant's class of common stock as of July 11, 2008: 10,675,390

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PART I

ITEM 1. FINANCIAL STATEMENTS

Heritage-Crystal Clean, Inc.
Consolidated Balance Sheets
(Unaudited)

| | | June 14, 2008 | | December 29, 2007 |
|---|---|---|---|---|
| ASSETS | | | | |
| Current Assets: | | | | |
| Cash and cash equivalents | $ | 434,391 | $ | 479,364 |
| Accounts receivable, net of allowance for doubtful accounts of $661,617 and $1,129,657 at June 14, 2008 and December 29, 2007, respectively | | 14,812,231 | | 13,446,073 |
| Inventory | | 13,426,349 | | 10,447,373 |
| Deferred income taxes | | 1,078,633 | | - |
| Prepaid and other current assets | | 1,349,639 | | 1,207,426 |
| Total Current Assets | | 31,101,243 | | 25,580,236 |
| Fixed assets, net of accumulated depreciation | | 20,238,045 | | 19,420,294 |
| Deferred offering costs | | - | | 1,275,694 |
| Deferred income taxes | | 380,084 | | - |
| Software and intangible assets, net of accumulated amortization | | 1,849,709 | | 1,707,395 |
| Total Assets | $ | 53,569,081 | $ | 47,983,619 |
| | | | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | | | |
| | | | | |
| Current Liabilities: | | | | |
| Accounts payable | $ | 6,354,266 | $ | 7,257,643 |
| Accrued salaries, wages, and benefits | | 1,579,422 | | 1,559,941 |
| Taxes payable | | 2,067,583 | | 983,128 |
| Other accrued expenses | | 1,079,128 | | 1,169,260 |
| Total Current Liabilities | | 11,080,399 | | 10,969,972 |
| Note payable - bank | | 1,705,000 | | 22,045,000 |
| Total Liabilities | | 12,785,399 | | 33,014,972 |
| | | | | |
| Redeemable Capital Units | | - | | 2,261,391 |
| | | | | |
| STOCKHOLDERS' EQUITY: | | | | |
| | | | | |
| Preferred members' capital | | - | | 14,703,813 |
| Common members' capital | | - | | 367,932 |
| Common stock - 15,000,000 Shares authorized at $0.01 par value, 10,675,390 shares issued and outstanding at June 14, 2008 | | 106,754 | | - |
| Additional paid-in capital | | 42,422,302 | | - |
| Accumulated deficit | | (1,745,374) | | (2,364,489) |
| Total Stockholders' Equity | $ | 40,783,682 | $ | 12,707,256 |

| | | | | |
|---|---|---|---|---|
| Total Liabilities and Stockholders' Equity | $ | 53,569,081 | $ | 47,983,619 |

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

Heritage-Crystal Clean, Inc.
Consolidated Statements of Operations
(Unaudited)

| | Second Quarter Ended June 14, 2008 | Second Quarter Ended June 16, 2007 | First Half Ended June 14, 2008 | First Half Ended June 16, 2007 |
|---|---|---|---|---|
| Sales | $ 24,837,826 | $ 20,386,092 | $ 47,835,269 | $ 39,574,192 |
| Cost of sales | 5,630,289 | 4,876,978 | 11,915,980 | 9,881,173 |
| Cost of sales - inventory impairment | - | - | - | 2,182,330 |
| Gross profit | 19,207,537 | 15,509,114 | 35,919,289 | 27,510,689 |
| Operating costs | 12,601,403 | 9,888,264 | 24,117,458 | 19,169,347 |
| Selling, general, and administrative expenses | 4,131,455 | 3,518,237 | 10,762,565 | 6,618,829 |
| Proceeds from contract termination | - | - | - | (3,000,000) |
| Operating income | 2,474,679 | 2,102,613 | 1,039,266 | 4,722,513 |
| Interest expense - net | 18,647 | 302,329 | 371,338 | 642,356 |
| Income before income taxes | 2,456,032 | 1,800,284 | 667,928 | 4,080,157 |
| Provision for income taxes | 1,046,644 | - | 2,026,814 | - |
| Net income (loss) | 1,409,388 | 1,800,284 | (1,358,886) | 4,080,157 |
| Preferred return | - | 390,299 | 339,188 | 780,598 |
| Net income (loss) available to common shareholders | $ 1,409,388 | $ 1,409,985 | $ (1,698,074) | $ 3,299,559 |
| | | | | |
| Net income (loss) per share available to common shareholders: basic | $ 0.13 | $ 0.20 | $ (0.19) | $ 0.46 |
| Net income (loss) per share available to common shareholders: diluted | $ 0.13 | $ 0.19 | $ (0.19) | $ 0.46 |
| | | | | |
| Pro forma data: | | | | |
| Net income (loss) | $ 1,409,388 | $ 1,800,284 | $ (1,358,886) | $ 4,080,157 |
| Pro forma provision for income taxes | - | 738,116 | 497,246 | 1,672,864 |
| Return on preferred and mandatorily redeemable capital units | - | 400,488 | 372,474 | 805,720 |
| Pro forma net income (loss) available to common members | $ 1,409,388 | $ 661,680 | $ (2,228,606) | $ 1,601,573 |
| | | | | |
| Pro forma net income (loss) per share: basic | $ 0.13 | $ 0.09 | $ (0.24) | $ 0.22 |
| Pro forma net income (loss) per share: diluted | $ 0.13 | $ 0.09 | $ (0.24) | $ 0.22 |
| | | | | |
| Number of weighted average common shares outstanding: basic | 10,675,390 | 7,181,790 | 9,147,554 | 7,172,830 |
| Number of weighted average common shares outstanding: diluted | 10,927,360 | 7,241,790 | 9,147,554 | 7,213,630 |

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

Heritage-Crystal Clean, Inc.
Consolidated Statement of Shareholders' Equity
(Unaudited)

| | Units/ Shares | Members' Capital | Par Value Common | Paid-in Capital Common | Retained Earnings (Deficit) | Total |
|---|---|---|---|---|---|---|
| Balance, December 29, 2007 | 24,152 | $ 15,071,745 | $ - | $ - | $ (2,364,489) | $ 12,707,256 |
| Distribution to preferred members | - | (10,886,826) | - | - | - | (10,886,826) |
| Tax distributions | - | (424,471) | - | - | (364,999) | (789,470) |
| Reorganization | 6,642,690 | (3,760,448) | 66,427 | 3,694,021 | - | - |
| Income tax benefit of reorganization | - | - | - | - | 2,343,000 | 2,343,000 |
| Net loss | - | - | - | - | (1,358,886) | (1,358,886) |
| Conversion of redeemable capital units | 564,100 | - | 5,641 | 2,255,750 | - | 2,261,391 |
| Proceeds from issuance of common stock, net | 3,401,100 | - | 34,011 | 33,211,096 | - | 33,245,107 |
| Share-based compensation | 67,500 | - | 675 | 3,261,435 | - | 3,262,110 |
| Balance, June 14, 2008 | 10,675,390 | $ - | $ 106,754 | $ 42,422,302 | $ (1,745,374) | $ 40,783,682 |

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

Heritage-Crystal Clean, Inc.
Consolidated Statements of Cash Flows
(Unaudited)

| | First Half Ended | |
|---|---|---|
| | June 14, 2008 | June 16, 2007 |
| Cash Flows from Operating Activities: | | |
| Net income (loss) | $ (1,358,886) | $ 4,080,157 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,597,273 | 1,243,554 |
| Bad debt provision | 379,011 | 296,567 |
| Share-based compensation | 3,262,110 | 149,430 |
| Non-cash inventory charge related to contract termination | - | 2,182,330 |
| Deferred tax expense | 884,283 | - |
| Changes in operating assets and liabilities: | | |
| Decrease (increase) in accounts receivables | (1,745,169) | (1,570,129) |
| Decrease (increase) in inventory | (2,978,976) | (2,296,837) |
| Decrease (increase) in prepaid and other current assets | (142,213) | 224,014 |
| Increase (decrease) in accounts payable | (520,600) | 1,255,859 |
| Increase (decrease) in accrued expenses | 1,013,805 | 540,891 |
| Cash provided by operating activities | 390,638 | 6,105,836 |
| | | |
| Cash flows from Investing Activities: | | |
| Capital expenditures | (2,278,837) | (2,741,694) |
| Software and intangible asset costs | (302,624) | (56,782) |
| Cash used in investing activities | (2,581,461) | (2,798,476) |
| | | |
| Cash flows from Financing Activities: | | |
| Deferred offering costs | - | (10,295) |
| Deferred financing costs | - | (23,686.00) |
| Proceeds from issuance of common stock, net of offering costs | 34,251,288 | - |
| Proceeds from note payable - bank | 23,775,000 | 9,059,000 |
| Repayments of note payable - bank | (44,115,000) | (10,484,000) |
| Common member contributions | - | 1,900.00 |
| Distributions to preferred members | (11,765,438) | (1,697,598) |
| Cash provided by (used in) financing activities | 2,145,850 | (3,154,679) |
| Net increase (decrease) in cash and cash equivalents | (44,973) | 152,681 |
| Cash and cash equivalents, beginning of period | 479,364 | 271,308 |
| Cash and cash equivalents, end of period | $ 434,391 | $ 423,989 |
| | | |
| Supplemental disclosure of cash flow information: | | |
| Cash paid for interest | $ 500,267 | $ 698,611 |
| Payables for construction in process | 50,500 | 656,989 |
| Payables for offering costs | 134,278 | - |
| Income taxes paid | 55,500 | - |

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

HERITAGE-CRYSTAL CLEAN, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 14, 2008
(Unaudited)

(1) ORGANIZATION AND NATURE OF OPERATIONS

Heritage-Crystal Clean, Inc. and its subsidiaries (the “Company”), a Delaware corporation, provides parts cleaning, hazardous and non-hazardous waste services to small and mid-sized customers in both the manufacturing and automotive service sectors. Our service programs include parts cleaning, containerized waste management, used oil collection, and vacuum truck services.

On March 12, 2008, Heritage-Crystal Clean, Inc. raised net proceeds of $33.2 million in an initial public offering and a direct placement (the “offerings”). Concurrently, the Company paid preferred members an accrued return through March 11, 2008 of $10.9 million as part of a reorganization, in which, prior to the consummation of the offerings, the members of Heritage-Crystal Clean, LLC and the former stockholders of BRS-HCC Investment Co., Inc. became stockholders of Heritage-Crystal Clean, Inc. (the “reorganization”). Further details regarding these transactions can be found below under the heading “Shareholders’ Equity.”

Prior to the completion of the reorganization, the Company filed an amendment to its certificate of incorporation with the Delaware Secretary of State, increasing its authorized capital to 15,000,000 shares of common stock at a par value of $0.01 per share and 500,000 shares of undesignated preferred stock.

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Principles of consolidation and basis of presentation

The Company conducts its primary business operations through Heritage-Crystal Clean, LLC., its wholly owned subsidiary and all intercompany balances have been eliminated in consolidation.

The unaudited interim financial statements included herein have been prepared by the Company in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and in accordance with Rule 10-01 of Regulation S-X of the Securities Exchange Act of 1934, as amended. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Operating results for interim periods are not necessarily indicative of results that may be expected for the year as a whole. In the opinion of the Company’s management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. These financial statements and notes thereto should be read in conjunction with the Company’s audited financial statements for the fiscal year ended December 29, 2007 filed with the Unites States Securities and Exchange Commission on a Registration Statement on Form S-1, as amended (SEC Reg. No. 333-143864)

The 2007 year-end consolidated balance sheet data included in this Form 10-Q was derived from the audited financial statements referenced above, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

GAAP requires the use of certain estimates by management in determining the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of sales and expenses during the reporting period. Significant items subject to such estimates and assumptions are the allowance for doubtful accounts receivable and valuation of inventory at lower of cost or market. Actual results could differ from those estimates.

The Company's fiscal year ends on the Saturday closest to December 31. The most recent fiscal year ended on December 29, 2007. Our convention with respect to reporting periodic financial data is such that each of our first three fiscal quarters consist of twelve weeks while our last fiscal quarter consists of sixteen or seventeen weeks. Interim results are presented for the twelve week periods and twenty-four week periods ended June 14, 2008 and June 16, 2007 each referred to as "second quarter ended" or "first half ended" or "fiscal first half ended".

(b) Income Taxes

In connection with the Company's reorganization and initial public offering, the Company became a 'C' corporation subject to federal and state income taxes. The Company accounts for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes ("SFAS No. 109"), under which deferred assets and liabilities are recognized based upon anticipated future tax consequences attributable to differences between financial statement carrying values of assets and liabilities and their respective tax bases. A valuation allowance is established to reduce the carrying value of deferred tax assets if it is considered more likely than not that such assets will not be realized. Any change in the valuation allowance would be charged to income in the period such determination was made.

Prior to converting to a 'C' corporation on March 11, 2008, the Company operated as a limited liability company and was taxed as a partnership. As such, the Company's income or losses were passed through to its owners who are liable for any related income taxes.

(c) Stock-Based Compensation

Effective January 1, 2006, the Company adopted FASB Statement No. 123(R), Share-Based Payment (Statement 123(R)). This statement replaces FASB Statement No. 123, Accounting for Stock-Based Compensation (Statement 123) and supersedes APB No. 25. Statement 123(R) and requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. This statement was adopted using the prospective method of application, which requires the Company to recognize compensation cost on a prospective basis. For share-based awards granted after January 1, 2006, the Company recognized compensation expense based on estimated grant date fair value.

Then Company values restricted stock as of the closing stock price on the grant date, then amortizes the expense on a straight-line basis in accordance with FASB Statement No. 123(R) over the remaining vesting period of the awards.

The Company estimates the fair value of stock options granted using the Black-Scholes-Merton option-pricing model and a single option award approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. The following assumptions are used in the Black-Scholes-Merton option pricing model:

Expected Term —The Company's expected term represents the period that the Company's stock-based awards are expected to be outstanding;

Expected Volatility —Due to the Company's limited trading history, the average volatility estimate used was determined by using a composite group of peer companies;

Expected Dividend —The Black-Scholes-Merton valuation model calls for a single expected dividend yield as an input. The Company currently pays no dividends and does not expect to pay dividends in the foreseeable future;

Risk-Free Interest Rate —The Company bases the risk-free interest rate on the implied yield currently available on United States Treasury zero-coupon issues with an equivalent remaining term.

(d) Recent Accounting Pronouncements

In December 2007, the FASB issued FASB Statement No. 141R, Business Combinations (Statement 141R) and FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements — an amendment to ARB No. 51 (Statement 160). Statements 141R and 160 require most identifiable assets, liabilities, noncontrolling interests, and goodwill acquired in a business combination to be recorded at "full fair value" and require noncontrolling interests (previously referred to as minority interests) to be reported as a component of equity, which changes the accounting for transactions with noncontrolling interest holders. Both Statements are effective for periods beginning on or after December 15, 2008, and earlier adoption is prohibited. Statement 141R will be applied to business combinations occurring after the effective date. Statement 160 will be applied prospectively to all noncontrolling interests, including any that arose before the effective date. The Company is currently evaluating the impact of adopting Statement 141R and Statement 160 on its results of operations and financial position .

(e) New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. This Statement applies to previous accounting pronouncements that require or permit fair value measurements. Accordingly, this Statement does not require any new fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. Delayed application is permitted for nonfinancial assets and nonfinancial liabilities except for items that are recognized or disclosed at fair value in the Financial Statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008. The Company has adopted SFAS 157 and the impact has been immaterial to the consolidated financial statements.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities — Including on amendment of FASB Statement No. 115 (SFAS 159). This standard amends SFAS 115, Accounting for Certain Investment in Debt and Equity Securities, with respect to accounting for a transfer to the trading category for all entities with available-for-sale and trading securities electing the fair value option. This standard allows companies to elect fair value accounting for many financial instruments and other items that currently are not required to be accounted as such, allows different applications for electing the option for a single item or groups of items, and requires disclosures to facilitate comparisons of similar assets and liabilities that are accounted for differently in relation to the fair value option. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company has adopted SFAS 159 and the impact has been immaterial to the consolidated financial statements.

(3) INVENTORY

The carrying value of inventory consisted of the following:

| | June 14, 2008 | December 29, 2007 |
|---|---|---|
| Machines | $ 2,321,437 | $ 2,227,933 |
| Solvents | 9,119,015 | 6,379,013 |
| Drums | 1,054,456 | 1,004,077 |
| Accessories | 931,441 | 836,350 |
| Total inventory | $ 13,426,349 | $ 10,447,373 |

(4) NOTE PAYABLE

The Company has a bank credit facility that provides for borrowings of up to $25 million. On March 3, 2008, the Company amended the credit facility to extend the maturity date of the credit facility to December 31, 2010. As of June 14, 2008 and December 29, 2007 $1.7 million and $22.0 million respectively, was outstanding under the credit facility. Under the terms of the credit facility, interest is payable monthly at the prime rate, unless the total leverage ratio is greater than or equal to 2.75 to 1. The weighted average effective interest rate for amounts outstanding was 6.83% and 8.34% at June 14, 2008 and December 29, 2007, respectively. Amounts borrowed under the credit facility are secured by a security interest in substantially all of the Company's tangible and intangible assets. As of June 14, 2008, the Company was in compliance with all covenants under its credit facility. As of June 14, 2008 and December 29, 2007 $23.3 million and $3.0 million respectively, were available under the credit facility.

(5) COMMITMENTS AND CONTINGENCIES

The Company is subject to contingencies as a result of environmental laws and regulations. The related future cost is not determinable due to such factors as the unknown timing and extent of corrective actions, if any, that may be required and also due to the application of joint and several liability. The Company believes, however, that any such costs will not have a material adverse effect on its financial position, future operations, or cash flows.

The Company leases office space, equipment, and vehicles under noncancelable operating lease agreements which expire through 2016. Rental expense under operating leases was approximately $1.8 million and $1.5 million for the second quarter of 2008 and 2007, respectively and $3.5 million and $3.0 million for the first half of 2008 and 2007, respectively.

Future minimum lease payments under noncancelable operating leases as of June 14, 2008 are as follows:

Fiscal period:

| | | |
|---|---|---|
| Remainder of | 2008 | $ 4,160,377 |
| | 2009 | 6,788,971 |
| | 2010 | 5,399,670 |
| | 2011 | 4,081,720 |
| | 2012 | 3,250,301 |
| Thereafter | | 3,944,262 |
| Total | | $ 27,625,301 |

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(6) INCOME TAXES

On March 11, 2008, in connection with the reorganization and the company converting from a limited liability company to a 'C' corporation, the company established beginning balances in its deferred tax assets and liabilities in accordance with SFAS No. 109. Accordingly, the Company recorded a cumulative net deferred tax asset of $0.1 million. Of this amount, a tax benefit of $2.3 million was recorded directly to equity in accordance with EITF 94-10, related to the increase in the tax basis of the Company's assets due to the reorganization. This was partially offset by a $2.2 million tax liability related to the change in tax status which was recorded as a component of the income tax provision.

Components of the Company's income tax benefit and provision for the period following the Company's conversion to a ‘C’ corporation on December 30, 2007 through June 14, 2008 including the $2.2 million deferred tax charge discussed above, are as follows:

| | | December 30, 2007 through June 14, 2008 |
|---|---|---|
| Current: | | |
| Federal | $ | 857,090 |
| State | | 285,441 |
| Total current | $ | 1,142,531 |
| Deferred: | | |
| Change in tax status | $ | 2,210,535 |