SYLVAN LEARNING SYSTEMS INC
Form 10-Q
November 12, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarter ended **September 30, 2002** or

o 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 0-22844

SYLVAN LEARNING SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Maryland	**52-1492296**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1001 Fleet Street, Baltimore, Maryland	**21202**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (410) 843-8000

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 ý. No o.

The registrant had 40,328,878 shares of Common Stock outstanding as of November 5, 2002.

SYLVAN LEARNING SYSTEMS, INC.
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SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES
Consolidated Balance Sheets
(Dollar and share amounts in thousands, except per share data)

	September 30, 2002	December 31, 2001
	(Unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 104,985	$ 102,194
Available-for-sale securities	39,221	60,091
Receivables:		
Accounts receivable	75,264	70,180
Costs and estimated earnings in excess of billings on uncompleted contracts	2,448	1,586
Notes receivable from tuition financing	4,160	7,545
Other notes receivable	21,345	15,810
Other receivables	2,891	3,725
	106,108	98,846
Allowance for doubtful accounts	(12,512)	(11,036)
	93,596	87,810
Inventory	6,981	7,344
Deferred income taxes	4,290	3,810
Prepaid expenses and other current assets	24,386	23,679
Total current assets	273,459	284,928

	September 30, 2002	December 31, 2001
Notes receivable from tuition financing, less current portion	4,762	8,636
Other notes receivable, less current portion	9,430	9,101
Property and equipment:		
Land	27,002	14,552
Buildings	147,486	88,190
Construction-in-progress	18,861	8,897
Furniture, computer equipment and software	130,501	115,140
Leasehold improvements	38,894	34,876
	362,744	261,655
Accumulated depreciation	(76,140)	(60,147)
	286,604	201,508
Intangible assets:		
Goodwill	281,197	285,784
Other intangible assets, net of accumulated amortization of $2,499 and $1,507, at September 30, 2002 and December 31, 2001, respectively	5,717	6,893
	286,914	292,677
Investments in and advances to affiliates	7,994	40,387
Other investments	22,343	32,567
Deferred income taxes	22,920	13,823
Deferred costs, net of accumulated amortization of $4,690 and $3,322 at September 30, 2002 and December 31, 2001, respectively	7,411	7,943
Other assets	24,695	17,621
Total assets	$ 946,532	$ 909,191

See accompanying notes to consolidated financial statements.

SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES
Consolidated Balance Sheets (Continued)
(Dollar and share amounts in thousands, except per share data)

	September 30, 2002	December 31, 2001
	(Unaudited)	
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 27,298	$ 15,696
Accrued expenses	60,922	49,386
Income taxes payable	21,776	29,754
Current portion of long-term debt	17,061	6,449

	September 30, 2002	December 31, 2001
Due to shareholders of acquired companies	20,354	3,657
Deferred revenue	73,530	54,578
Other current liabilities	1,030	8,154
Total current liabilities	221,971	167,674
Long-term debt, less current portion	144,643	124,474
Deferred income taxes	7,937	
Other long-term liabilities	18,595	14,207
Total liabilities	393,146	306,355
Minority interest	68,947	56,981
Stockholders' equity:		
Preferred stock, par value $0.01 per share authorized 10,000 shares, no shares issued and outstanding as of September 30, 2002 and December 31, 2001		
Common stock, par value $0.01 per share authorized 90,000 shares, issued and outstanding shares of 40,332 as of September 30, 2002 and 38,742 as of December 31, 2001	402	387
Additional paid-in capital	257,829	229,386
Retained earnings	252,962	342,786
Accumulated other comprehensive loss	(26,754)	(26,704)
Total stockholders' equity	484,439	545,855
Total liabilities and stockholders' equity	$ 946,532	$ 909,191

See accompanying notes to consolidated financial statements.

SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES
Consolidated Statements of Operations
(Dollar and share amounts in thousands, except per share data)

	Three months ended September 30, 2002	Three months ended September 30, 2001
	(Unaudited)	
Revenues		
Core operating segments	$ 124,515	$ 104,918
Sylvan Ventures	6,948	141

	Three months ended September 30,	
Total revenues	131,463	105,059
Costs and expenses		
Direct costs:		
Core operating segments	108,223	92,901
Sylvan Ventures	12,823	3,287
General and administrative expenses:		
Core operating segments	5,207	5,643
Sylvan Ventures	1,344	1,633
Loss on assets sold	3,000	
Total costs and expenses	130,597	103,464
Operating income	866	1,595
Other income (expense)		
Investment and other income	1,543	2,441
Interest expense	(2,067)	(2,402)
Sylvan Ventures investment income	172	22,842
Loss on investment	(7,359)	
Equity in net loss of affiliates:		
Sylvan Ventures	(965)	(10,830)
Other	72	
	(893)	(10,830)
Minority interest in consolidated subsidiaries:		
Sylvan Ventures	975	(20)
Other	(762)	(1,021)
	213	(1,041)
Income (loss) before income taxes	(7,525)	12,605
Income tax benefit (expense)	1,834	(4,236)
Net income (loss)	$ (5,691)	$ 8,369
Earnings (loss) per common share:		
Basic	$ (0.14)	$ 0.22
Diluted	$ (0.14)	$ 0.20

See accompanying notes to consolidated financial statements.

SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES
Consolidated Statements of Operations
(Dollar and share amounts in thousands, except per share data)

	Nine months ended September 30, 2002	2001
	(Unaudited)	
Revenues		
Core operating segments	$ 412,863	$ 347,383
Sylvan Ventures	16,390	204
Total revenues	429,253	347,587
Costs and expenses		
Direct costs:		
Core operating segments	353,480	299,256
Sylvan Ventures	33,762	10,446
General and administrative expenses:		
Core operating segments	16,028	17,530
Sylvan Ventures	3,614	6,955
Loss on assets sold	20,244	
Total costs and expenses	427,128	334,187
Operating income	2,125	13,400
Other income (expense)		
Investment and other income	3,843	7,586
Interest expense	(6,446)	(6,873)
Sylvan Ventures investment income	445	22,204
Loss on investment	(7,359)	(14,231)
Equity in net loss of affiliates:		
Sylvan Ventures	(4,631)	(46,204)
Other	35	(263)
	(4,596)	(46,467)
Minority interest in consolidated subsidiaries:		
Sylvan Ventures	2,203	3,076
Other	(4,228)	(5,041)
	(2,025)	(1,965)
Loss before income taxes and cumulative effect of change in accounting principle	(14,013)	(26,346)
Income tax benefit	2,823	9,696
Loss before cumulative effect of change in accounting principle	(11,190)	(16,650)
Cumulative effect of change in accounting principle, net of income tax benefit of $7,700	(78,634)	
Net loss	$ (89,824)	$ (16,650)
Loss per common share, basic and diluted:		
Loss before cumulative effect of change in accounting principle	$ (0.28)	$ (0.44)

	Nine months ended September 30,	
Net loss	$ (2.25)	$ (0.44)

See accompanying notes to consolidated financial statements

SYLVAN LEARNING SYSTEMS, INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(Amounts in thousands)

	Nine months ended September 30,	
	2002	2001
	(Unaudited)	
Operating activities		
Net loss	$ (89,824)	$ (16,650)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Cumulative pre-tax effect of change in accounting principle	86,334	
Depreciation	20,500	17,087
Amortization	1,307	11,190
Loss on assets sold	20,244	
Deferred income taxes	2,009	(162)
Loss (gain) on investments	6,914	(7,973)
Equity in net loss of affiliates	4,596	46,467
Minority interest in income of consolidated subsidiaries	2,025	1,965
Other non-cash items	44	1,104
Changes in operating assets and liabilities:		
Receivables	(10,434)	3,891
Tuition loans, net	5,536	(4,496)
Inventory, prepaid expenses and other current assets	(1,852)	710
Payables and accrued expenses	12,384	(4,804)
Income taxes payable	(11,552)	(112,993)
Deferred revenue and other current liabilities	5,186	(11,966)
Net cash provided by (used in) operating activities	53,417	(76,630)
Investing activities		
Purchase of available-for-sale securities	(17,592)	(108,045)
Proceeds from sale or maturity of available-for-sale securities	38,674	251,118
Cash paid for investments in and advances to affiliates	(2,989)	(38,228)
Proceeds from sale of investments in affiliates	8,000	
Purchase of property and equipment	(46,835)	(40,356)
Cash paid for acquired businesses, net of cash received	(37,666)	(11,285)
Payment of contingent consideration for prior period acquisitions	(775)	(39,491)
Expenditures for deferred contract costs	(2,508)	(2,936)
Increase in other assets	(2,067)	(1,859)

	Nine months ended September 30,	
Net cash provided by (used in) investing activities	(63,758)	8,918
Financing activities		
Proceeds from exercise of options	14,694	15,010
Proceeds from issuance of debt	19,486	23,212
Payments on debt	(16,648)	(19,118)
Cash received from minority members of Sylvan Ventures	11,552	23,272
Cash distributed to minority members of Sylvan Ventures	(12,000)	
Increase (decrease) in other long-term liabilities and other financing activities	(1,359)	736
Net cash provided by financing activities	15,725	43,112
Effect of exchange rate changes on cash	(2,593)	(1,453)
Net increase (decrease) in cash and cash equivalents	2,791	(26,053)
Cash and cash equivalents at beginning of period	102,194	116,490
Cash and cash equivalents at end of period	$ 104,985	$ 90,437

See accompanying notes to consolidated financial statements.

Sylvan Learning Systems, Inc. and Subsidiaries
Notes to Consolidated Financial Statements
Unaudited
(Dollar and share amounts in thousands, except per share amounts)

September 30, 2002

Note 1 Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month and nine month periods ended September 30, 2002 are not necessarily indicative of the results that may be expected for the year ended December 31, 2002. The traditional semester programs in the education industry, with a summer break, result in large seasonality in the operating results of Sylvan Learning Systems, Inc. (the "Company"). The consolidated balance sheet at December 31, 2001 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. For further information, refer to the audited consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2001.

Core operating segments include the operating results of the following business segments: K-12 Education Services, Online Higher Education, International Universities and English Language Instruction-Spain. Sylvan Ventures revenues and direct costs include the operating results of its consolidated investments (refer to Note 6 for further information). Sylvan Ventures general and administrative expenses include the costs incurred to oversee its investments, to build its investment portfolio and costs included in the start-up phase of consolidated businesses prior to the generation of operating revenues.

Certain amounts previously reported for 2001 have been reclassified to conform with the 2002 presentation.

Note 2 New Accounting Standards

In June 2001, the Financial Accounting Standards Board issued Statement No. 142, *Goodwill and Other Intangible Assets,* which established financial accounting and reporting standards for acquired goodwill and other intangible assets. Under Statement No. 142, goodwill and indefinite-lived intangible assets are no longer amortized but are subject to annual impairment tests in accordance with the new standard. Other intangible assets that have finite lives will continue to be amortized over their useful lives. The Company adopted Statement No. 142 effective January 1, 2002. Refer to Note 5 for further information.

In August 2001, the Financial Accounting Standards Board issued Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Statement No. 144 supersedes Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and provides a single accounting model for long-lived assets to be held and used or to be disposed of. The Company adopted Statement No. 144 effective January 1, 2002 and the adoption of the new standard did not have a material impact on the Company's consolidated financial position or results of operations.

Note 3 Loss on Assets Sold

In June 2002, the Company adopted a plan to sell the portion of its English Language Instruction segment that is located in Spain ("WSI Spain"). As a result of the pending sale and an estimate of the likely sale proceeds, the Company recognized an impairment charge of $17,244 in June 2002 related to WSI Spain. In the third quarter of 2002, the Company completed the sale of WSI Spain and as a result recognized an additional loss of $3,000. These losses are included in loss on assets sold in the consolidated statements of operations.

The remaining English Language Instruction businesses are now included in the International Universities segment to reflect the combination of business management and the interrelationship of the Wall Street Institute operations and the university programs.

Note 4 Acquisitions

Effective January 1, 2002, the Company acquired substantially all of the net operating assets of three Sylvan Learning Center franchise businesses, comprising 30 centers, for an initial cash payment of $11,000 and 144 shares of Sylvan common stock with a quoted market value of $3,000. The purchase agreement required the Company to pay additional consideration to the sellers in the event that specified levels of operating results were achieved in 2002, 2003, 2004 and 2005. As of September 30, 2002, the Company recorded $6,900 as a liability in final settlement of all remaining contingent payments. This amount was paid in October 2002. The purchase price totaled approximately $21,010, including acquisition costs of $110. The purchase price was allocated to acquired assets totaling $22,999 and assumed liabilities of $1,989. The preliminary allocation of the purchase price is subject to revision based on the final determination of the fair value of certain acquired intangible assets. The final purchase price may differ from this preliminary amount due to adjustment to acquisition related costs. The results of operations of the acquired franchises are included in the accompanying financial statements commencing on January 1, 2002.

In connection with the settlement of the contingent purchase price of these Learning Center franchises, the Company entered into an agreement with the sellers, effective August 31, 2002, to repurchase the franchise rights in the United Kingdom and France for cash of $9,179. The amount was paid in October 2002. The initial purchase price was allocated to acquired assets totaling $9,369 and assumed liabilities of $190. The preliminary allocation of the purchase price is subject to revision based on the final determination of the fair value of certain acquired intangible assets. The final purchase price may differ from this preliminary amount due to adjustment to acquisition related costs.

On February 1, 2002, Sylvan Ventures exercised its option to acquire an additional 10% ownership of common stock in Walden E-Learning, Inc. ("Walden") for $8,000, increasing its ownership percentage in Walden to 51%. Prior to the exercise of its option, Sylvan Ventures had acquired a 41% stake in Walden for $32,800 in February 2001. The transactions have been accounted for as a step acquisition with a total purchase price of $39,892, after subtracting previously recorded equity in net losses. The purchase price was allocated to acquired assets totaling $45,451 and assumed liabilities of $5,559. The preliminary allocation of the purchase price is subject to revision based on the final determination of the fair value of certain acquired intangible assets. The final purchase price may differ from this preliminary amount due to adjustment to acquisition related costs. The results of operations of Walden are consolidated in the accompanying financial statements commencing on February 1, 2002.

On March 1, 2002, the Company acquired for cash all of the outstanding common stock of Hedleton Holding, N.V., which owns all of the capital stock of Escuela Superior De Alta Gestion De Hotel, S.A. ("Marbella"), a private for-profit university located in Marbella, Spain. Marbella was previously a franchise of Swiss Hotel Association Hotel Management School Les Roches ("Les Roches"), which was acquired by the Company in 2000. The purchase price for the outstanding common stock totaled approximately $6,987, including acquisition costs of $552. The purchase price was allocated to acquired assets totaling $9,572 and assumed liabilities of $2,585. The preliminary allocation of the purchase price is subject to revision based on the final determination of the fair value of certain acquired intangible assets. The final purchase price may differ from this preliminary amount due to adjustment to acquisition related costs. The results of operations of Marbella are included in the accompanying financial statements commencing on March 1, 2002.

Effective May 1, 2002, the Company acquired an additional 20% ownership interest in Desarrollo del Conocimiento S.A. ("Decon"), a consolidated holding company that controls and operates the Universidad de Las Americas ("UDLA"), for cash of approximately $6,500, increasing its total ownership in Decon to 80%. The purchase price of the additional interest was accounted for as a step acquisition and was allocated to acquired assets of $6,500. The preliminary allocation of this additional purchase price is subject to revision based on the final determination of the fair value of certain acquired intangible assets.

Effective August 1, 2002, the Company acquired for cash all of the outstanding common stock of the Glion Group, S.A., the parent company of Glion Hotel School, S.A. ("Glion"), a leading hotel management school in Switzerland. The initial purchase price totaled approximately $11,671, including acquisition costs of $900. Additionally, the Company is required to make payments of $2,020 and $3,392 on August 30, 2003 and August 30, 2004, respectively. The purchase agreement includes a provision for a possible reduction in the purchase price of up to $1,482, based on the working capital of Glion at the acquisition date. The Company believes that it is probable this contingency will be resolved in its favor and, therefore, has recorded the purchase price net of this contingency. The initial purchase price was allocated to acquired assets totaling $58,118 and assumed liabilities of $42,517. The preliminary allocation of the purchase price is subject to revision based on the final determination of the fair value of certain acquired intangible assets. The final purchase price may differ from this preliminary amount due to adjustment to acquisition related costs. The results of operations of Glion are included in the accompanying financial statements commencing on August 1, 2002.

Note 5 Goodwill and Other Intangible Assets

Statement No. 142 requires that goodwill be tested for impairment at the reporting unit level at the time of its adoption and at least annually thereafter, utilizing a two-step methodology. The initial step required the Company to determine the fair value of each reporting unit and compare it to the carrying value, including goodwill, of such unit. When the fair value of the reporting unit exceeded the carrying value, no impairment loss was recognized. The second step required the Company to determine the implied fair value of goodwill. When the carrying value of the reporting unit goodwill exceeded the implied fair value of that goodwill, an impairment loss was recognized in an amount equal to that excess, not exceeding the carrying value of the goodwill. The fair values of reporting units

and the related implied fair values of their respective goodwill were determined using discounted cash flows.

As a result of testing goodwill for impairment in accordance with Statement No. 142, as of January 1, 2002, the Company recorded a non-cash charge of $78,634, net of income tax benefit of $7,700, which