AVALON HOLDINGS CORP
Form 10-Q
November 13, 2014
2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2014

[ ] 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 1-14105

AVALON HOLDINGS CORPORATION

(Exact name of registrant as specified in its charter)

Ohio	**34-1863889**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One American Way, Warren, Ohio	**44484-5555**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(330) 856-8800**

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

The registrant had 3,191,100 shares of its Class A Common Stock and 612,231 shares of its Class B Common Stock outstanding as of November 10, 2014.

AVALON HOLDINGS CORPORATION AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

AVALON HOLDINGS CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations (Unaudited)

(in thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Net operating revenues	$14,437	$16,386	$37,436	$46,788
Costs and expenses:				
Costs of operations	11,572	13,432	30,872	39,024
Depreciation and amortization	579	408	1,562	1,217
Selling, general and administrative expenses	2,155	2,145	5,831	5,939
Operating income (loss)	131	401	(829)	608
Other income (expense):				
Interest expense	(21)	(6)	(31)	(16)
Interest income	1	—	1	1
Other income, net	51	56	213	232
Income (loss) before income taxes	162	451	(646)	825
Provision for income taxes	28	36	58	95
Net income (loss)	134	415	(704)	$730
Less net income (loss) attributable to non-controlling interest in subsidiary	36	—	(15)	—
Net income (loss) of Avalon Holdings Corporation common shareholders	$98	$415	$(689)	$730
Income (loss) per share attributable to Avalon Holdings Corporation common shareholders:				
Basic net income (loss) per share	$.03	$.11	$(.18)	$.19
Dilutive net income (loss) per share	$.02	$.10	$(.18)	$.18

Weighted average shares outstanding – basic	3,803	3,803	3,803	3,803
Weighted average shares outstanding – diluted	4,078	4,103	3,803	4,060

See accompanying notes to condensed consolidated financial statements.

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AVALON HOLDINGS CORPORATION AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(in thousands, except per share amounts)

	September 30, 2014 (Unaudited)	December 31, 2013
Assets:		
Current Assets:		
Cash and cash equivalents	$ 6,166	$ 9,798
Accounts receivable, net	9,656	10,201
Prepaid expenses	591	349
Refundable income taxes	3	3
Other current assets	1,015	830
Total current assets	17,431	21,181
Property and equipment, less accumulated depreciation and amortization of $14,693 in 2014 and $13,556 in 2013	33,254	27,563
Leased property under capital leases, less accumulated depreciation and amortization of $3,755 in 2014 and $3,397 in 2013	6,511	6,719
Noncurrent deferred tax asset	8	8
Other assets, net	911	108
Total assets	$ 58,115	$ 55,579
Liabilities and Shareholders' Equity		
Current Liabilities:		
Current portion of obligations under capital leases	$ 57	$ 56
Revolving line of credit	2,900	—
Accounts payable	6,485	8,101
Accrued payroll and other compensation	888	549
Accrued income taxes	6	1
Other accrued taxes	315	307
Deferred revenues	2,623	2,265
Other liabilities and accrued expenses	802	365
Total current liabilities	14,076	11,644
Obligations under capital leases	349	390
Asset retirement obligation	75	75
Deferred rental income	160	—
Equity:		
Class A Common Stock, $.01 par value	32	32

Class B Common Stock, $.01 par value	6	6
Paid-in capital	58,848	58,771
Accumulated deficit	(19,078)	(18,389)
Total Avalon Holdings Corporation shareholders' equity	39,808	40,420
Non-controlling interest in subsidiary	3,647	3,050
Total Equity	43,455	43,470
Total liabilities and equity	$ 58,115	$ 55,579

See accompanying notes to condensed consolidated financial statements.

AVALON HOLDINGS CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows (Unaudited)

(in thousands)

	Nine Months Ended September 30,	
	2014	2013
Operating activities:		
Net (loss) income	$(704)	$730
Reconciliation of (loss) income to cash provided by operating activities:		
Depreciation and amortization	1,562	1,217
Compensation costs – stock options	60	96
Deferred rental income	(16)	—
Provision for losses on accounts receivable	33	15
Gain from disposal of property and equipment	(2)	(20)
Change in operating assets and liabilities:		
Accounts receivable	512	(2,053)
Prepaid expenses	(242)	(50)
Other current assets	(185)	(119)
Other assets, net	12	(4)
Accounts payable	(1,939)	957
Accrued payroll and other compensation	339	318
Accrued income taxes	5	32
Other accrued taxes	8	(75)
Deferred revenues	358	442
Other liabilities and accrued expenses	346	77
Net cash provided by operating activities	147	1,563
Investing activities:		
Capital expenditures	(4,161)	(820)
Acquisition of Magnuson Grand Hotel	(3,122)	—
Proceeds from disposal of property and equipment	14	20
Net cash used in investing activities	(7,269)	(800)
Financing activities:		
Proceeds from subsidiary private placement offering	700	—
Borrowing under line of credit	2,900	—
Cash distributions to non-controlling interest in subsidiary	(87)	—
Principal payments on capital lease obligations	(40)	(40)

Contribution to paid-in capital	17	7
Net cash provided by (used in) financing activities	3,490	(33)
(Decrease) increase in cash and cash equivalents	(3,632)	730
Cash and cash equivalents at beginning of year	9,798	7,888
Cash and cash equivalents at end of period	$6,166	$8,618
Supplemental disclosures of cash flow information:		
Significant non-cash investing activities and financing activities:		
Capital lease obligations incurred	$—	$280
Significant non-cash operating and investing activities		
Deferred rental income for the acquisition of The Magnuson Grand Hotel	$266	$—
Capital expenditures included in accounts payable at September 30, 2014	$323	$—

See accompanying notes to condensed consolidated financial statements.

AVALON HOLDINGS CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

(Unaudited)

September 30, 2014

Note 1. Basis of Presentation

The unaudited condensed consolidated financial statements of Avalon Holdings Corporation and subsidiaries (collectively "Avalon") and related notes included herein have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been omitted consistent with such rules and regulations. The accompanying unaudited condensed consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and related notes included in Avalon's 2013 Annual Report to Shareholders.

In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the financial position of Avalon as of September 30, 2014, and the results of its operations and cash flows for the interim periods presented.

The operating results for the interim periods are not necessarily indicative of the results to be expected for the full year.

Note 2. Subsequent Events

Avalon evaluated subsequent events through the date the financial statements were issued.

Note 3. Acquisition

On August 1, 2014, Avalon Holdings Corporation (“Avalon”), through a wholly owned subsidiary, completed the acquisition of The Magnuson Grand Hotel (formerly The Avalon Inn) in Howland, Ohio for $3.1 million in cash and the assumption of certain operating leases and some rental payment relief. The transaction also includes the purchase of the adjoining tennis center. The hotel is located adjacent to Avalon’s corporate headquarters and its Avalon Lakes Golf Course.

The acquisition has been accounted for using the acquisition method in accordance with the Financial Accounting Standards Board, Accounting Standards Codification Topic 805, *Business Combinations*. The assets acquired were recorded at their fair values as of the date of acquisition. The preliminary purchase price allocation was as follows:

Property and equipment	$2,570,000
Other intangible assets	818,000
Deferred rental income	(266,000)
Net assets acquired	$3,122,000

The purchase price allocation is provisional, pending completion of the valuation of acquired property, buildings, furniture and fixtures and any intangible assets including goodwill. The other intangible assets are included in the Condensed Consolidated Balance Sheets under the caption “Other assets, net.” Avalon is utilizing a third party to assist in the fair value determination of certain components of the purchase price allocation. The final valuation may change the allocation of the purchase price, which could affect the fair values assigned to the assets. Avalon incurred $67,000 in acquisition related costs. Such amount is included in selling, general and administrative expenses. The amount of net operating revenues and net income of The Magnuson Grand Hotel included in Avalon’s Condensed Consolidated Statements of Operations from the acquisition date to the period ending September 30, 2014 are net operating revenues of $.3 million and $9,000 of net income.

Pro Forma Consolidated Results

The following supplemental pro forma information presents the financial results for the three and nine months ended September 30, 2014 as if the acquisition had occurred on January 1, 2014 and for the three and nine months ended September 30, 2013 as if the acquisition had occurred on January 1, 2013. The pro forma results do not include any anticipated effects of the planned integration of The Magnuson Grand Hotel with the golf and related operations segment.

Accordingly, such pro forma amounts are not necessarily indicative of the results that actually would have occurred had the acquisition been completed on the dates indicated, nor are they indicative of the future operating results of the combined company.

Pro forma consolidated results (in thousands, except for per share data):	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Net operating revenues	$14,550	$16,835	$38,223	$48,153
Net income (loss)	$75	$393	$(843)	$754
Basic income (loss) per share	$0.02	$0.10	$(0.22)	$0.20
Diluted income (loss) per share	$0.02	$0.10	$(0.22)	$0.19

Note 4. Net Income (Loss) per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the periods presented, which was 3,803,331 for each period.

Diluted net income (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding plus any weighted common equivalent shares determined to be outstanding during the period using the treasury method. The weighted common equivalent shares included in the calculation are related to stock options granted by Avalon where the weighted average market price of Avalon's common stock for the period presented is greater than the option exercise price of the stock option. For the three months ended September 30, 2014, the diluted weighted average number of shares outstanding was 4,077,991. For the three months and nine months ended September 30, 2013 the diluted weighted average number of shares outstanding was 4,102,594 and 4,060,401, respectively. For the nine months ended September 30, 2014, the diluted per share amount is equal to the basic per share amount because Avalon was in a net loss position and as a result, such dilution would be considered anti-dilutive. However, assuming dilution, the diluted weighted average number of common shares outstanding for the nine months ended September 30, 2014 was 4,132,344.

Note 5. Credit Facility

On July 22, 2014 Avalon increased its unsecured line of credit agreement with The Huntington National Bank from $1 million to $5 million. Interest on borrowings accrues at LIBOR plus 2.70% and has a .25% nonuse fee. The line of credit is renewed annually on April 30 and contains certain financial and other covenants, customary representations, warranties and events of defaults. On August 1, 2014 Avalon borrowed $2.9 million. These monies were utilized to purchase The Magnuson Grand Hotel. At September 30, 2014 the outstanding borrowings were $2.9 million. At December 31, 2013, there were no borrowings under the line of credit.

Note 6. Income Taxes

Avalon recorded net income of $.1 million in the third quarter of 2014 compared with net income of $.4 million in the third quarter of 2013. Avalon recorded a state income tax provision in both the third quarter of 2014 and 2013, which was related entirely to the waste management and brokerage operations. Excluding the effect of this state tax provision, Avalon’s overall effective tax rate was 0% in the third quarter of 2014 and 2013. The income tax provision for the third quarter of 2014 and 2013 were offset by a change in the valuation allowance. The overall effective tax rate is different than statutory rates primarily due to a change in the valuation allowance. A valuation allowance is provided when it is more likely than not that deferred tax assets relating to certain federal and state loss carryforwards will not be realized. Avalon continues to maintain a valuation allowance against the majority of its deferred tax amounts until it is evident that the deferred tax asset will be utilized in the future.

Avalon incurred a net loss of $.7 million for the first nine months of 2014 compared with net income of $.7 million for the first nine months of the prior year. Avalon recorded a state income tax provision for the first nine months of 2014 and 2013, which was related entirely to the waste management and brokerage operations. Excluding the effect of this state tax provision, Avalon’s overall effective tax rate was 0% in both the first nine months of 2014 and 2013. The income tax benefit for the first nine months of 2014 and the income tax provision for the first nine months of 2013 were offset by a change in the valuation allowance. A valuation allowance is provided when it is more likely than not that deferred tax assets relating to certain federal and state loss carryforwards will not be realized. The overall effective tax rate differs from statutory rates primarily due to the change in the valuation allowance.

Note 7. Long-term Incentive Plan

The purpose of the Avalon Holdings Corporation 2009 Long-term Incentive Plan (the “Plan”) is (a) to improve individual employee performance by providing long-term incentives and rewards to employees of Avalon, (b) to assist Avalon in attracting, retaining and motivating employees and non-employee directors with experience and ability, and (c) to associate the interests of such employees and directors with those of the Avalon shareholders. Under the Plan, 1,300,000 shares have been reserved for the issuance of stock options. At September 30, 2014 there were 760,000 options outstanding. The stock options, vest ratably over a five year period and have a contractual term of ten years from the date of grant. At the end of each contractual vesting period, the share price of the Avalon common stock, traded on a public stock exchange (NYSE Amex), must reach a predetermined price within three years following such contractual vesting period before the stock options are exercisable (See table below). If the Avalon common stock price does not reach the predetermined price, the stock options will either be cancelled or the period will be extended at the discretion of the Board of Directors.

The Monte Carlo Simulation was selected to determine the fair value because it incorporates six minimum considerations; 1) the exercise price of the option, 2) the expected term of the option, taking into account both the contractual term of the option, the effects of employees’ expected exercise and post-vesting employment termination behavior, as well as the possibility of change in control events during the contractual term of the option agreements, 3) the current fair value of the underlying equity, 4) the expected volatility of the value of the underlying share for the expected term of the option, 5) the expected dividends on the underlying share for the expected term of the option and 6) the risk-free interest rate(s) for the expected term of the option.

The expected term, or time until the option is exercised is typically based on historical exercising behavior of previous option holders of a company’s stock. Due to the fact that no options have been exercised as of yet, and therefore no historical exercising behavior available, an alternative method was used. Because of the nature of the vesting as described above, the options were separated into five blocks, with each block having its own vesting period and expected term. Assuming the vesting occurs ratably over the vesting period for each option block, the average vesting term (requisite service period) for each option block was calculated to be 2.54, 3.54, 4.54, 5.54 and 6.54 years for option blocks 1 through 5, respectively. As such, the expected terms were calculated to be 6.27, 6.77, 7.27, 7.77 and 8.27 years, for option blocks 1 through 5, respectively.

The current fair value of the underlying equity was determined to be equal to Avalon’s publicly traded stock price as of the grant dates times the sum of the Class A and Class B common shares outstanding.

The expected volatility was based on the observed volatility of Avalon common stock for a five year period prior to the grant dates. The expected volatility that was used ranged from 60.9% to 61.7% with a weighted average expected volatility of 61.2%.

There were no expected dividends and the risk-free interest rate(s), which ranged from 2.06% to 2.28%, were based on yield data for U. S. Treasury securities over a period consistent with the expected term.

The following information is a summary of the stock option activity:

Options outstanding at January 1, 2014	760,000
Options forfeited	0
Options cancelled	0
2014 Options granted	0
Total options outstanding at September 30, 2014	760,000
Options Vested	552,000
Options Exercisable	304,000

Number of Options Granted	Weighted Average Exercise Price	Weighted Average Fair Value at Grant Date
760,000	$ 2.63	$ 1.09

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The stock options vest and become exercisable based upon achieving two critical metrics as follows:

1) Contract Vesting Term: The stock options vest ratably over a five year period.
2) The Avalon common stock price traded on a public stock exchange (NYSE Amex) must reach the predetermined vesting price within three years after the options become vested under the Contract Vesting Term.

The table below represents the period and predetermined stock price needed for vesting.

	Begins Vesting	Ends Vesting	Predetermined Vesting Price
Block 1	12 mo. after Grant Dates	48 mo. after Grant Dates	$ 3.43
Block 2	24 mo. after Grant Dates	60 mo. after Grant Dates	$ 4.69
Block 3	36 mo. after Grant Dates	72 mo. after Grant Dates	$ 6.43
Block 4	48 mo. after Grant Dates	84 mo. after Grant Dates	$ 8.81
Block 5	60 mo. after Grant Dates	96 mo. after Grant Dates	$ 12.07

Compensation cost was approximately $19,000 and $44,000 for the three months ended September 30, 2014 and 2013, respectively, and $60,000 and $96,000 for the nine months ended September 30, 2014 and 2013, respectively, based upon the estimated fair value calculation. As of September 30, 2014, there was approximately $115,000 of total unrecognized compensation costs related to non-vested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over a weighted-average period of 1.46 years.

Note 8. Legal Matters

In the ordinary course of conducting its business, Avalon becomes involved in lawsuits, administrative proceedings and governmental investigations, including those related to environmental matters. Some of these proceedings may result in fines, penalties or judgments being assessed against Avalon which, from time to time, may have an impact on its business and financial condition. Although the outcome of such lawsuits or other proceedings cannot be predicted with certainty, Avalon does not believe that any uninsured ultimate liabilities, fines or penalties resulting from such pending proceedings, individually or in the aggregate, will have a material adverse effect on its liquidity, financial position or results of operations.

Note 9. Business Segment Information

Avalon's reportable segments include waste management services and golf and related operations. In determining the segment information, Avalon considered its operating and management structure and the types of information subject to regular review by its "chief operating decision maker." On this basis, Avalon's reportable segments include waste management services and golf and related operations. Avalon accounts for intersegment net operating revenues as if the transactions wer