

VECTOR GROUP LTD
Form 10-Q
October 31, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For The Quarterly Period Ended September 30, 2012

VECTOR GROUP LTD.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation incorporation or organization)	1-5759 Commission File Number	65-0949535 (I.R.S. Employer Identification No.)
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100 S.E. Second Street
Miami, Florida 33131
305/579-8000
(Address, including zip code and telephone number, including area code,
of the principal executive offices)

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, as amended (the "Exchange Act"), 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. x Yes o 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). x Yes o 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 definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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(Do not check if a smaller
reporting company)

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

At October 31, 2012, Vector Group Ltd. had 87,003,808 shares of common stock outstanding.

VECTOR GROUP LTD.

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VECTOR GROUP LTD. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

	September 30, 2012	December 31, 2011
ASSETS:		
Current assets:		
Cash and cash equivalents	\$217,256	\$240,923
Investment securities available for sale	65,193	76,486
Accounts receivable - trade, net	11,567	24,869
Inventories	106,439	109,228
Deferred income taxes	39,880	42,951
Income tax receivable, net	823	9,553
Restricted assets	1,476	1,474
Other current assets	4,549	4,257
Total current assets	447,183	509,741
Property, plant and equipment, net	56,909	56,556
Investment in Escena, net	13,174	13,280
Long-term investments accounted for at cost	16,368	5,675
Long-term investments accounted for under the equity method	6,152	16,499
Investments in non-consolidated real estate businesses	123,877	124,469
Restricted assets	10,777	9,626
Deferred income taxes	50,647	31,017
Intangible asset	107,511	107,511
Prepaid pension costs	11,171	10,047
Other assets	41,872	43,347
Total assets	\$885,641	\$927,768
LIABILITIES AND STOCKHOLDERS' DEFICIENCY:		
Current liabilities:		
Current portion of notes payable and long-term debt	\$ 15,628	\$50,844
Current portion of fair value of derivatives embedded within convertible debt	—	84,485
Current payments due under the Master Settlement Agreement	104,207	51,174
Current portion of employee benefits	1,000	2,690
Accounts payable	5,388	9,532
Accrued promotional expenses	16,999	17,056
Income taxes payable, net	6,730	6,597
Accrued excise and payroll taxes payable, net	235	17,992
Litigation accruals	1,336	1,551
Deferred income taxes	29,256	35,885
Accrued interest	9,332	20,888
Other current liabilities	14,085	16,504
Total current liabilities	204,196	315,198
Notes payable, long-term debt and other obligations, less current portion	515,015	493,356
Fair value of derivatives embedded within convertible debt	87,466	49,015
Non-current employee benefits	45,097	45,982
Deferred income taxes	81,187	60,642
Payments due under the Master Settlement Agreement	52,022	49,338
Litigation accruals	1,809	1,600
Other liabilities	1,797	1,667

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Total liabilities	988,589	1,016,798
Commitments and contingencies		
Stockholders' deficiency:		
Preferred stock, par value \$1.00 per share, 10,000,000 shares authorized	—	—
Common stock, par value \$0.10 per share, 150,000,000 shares authorized, 90,763,670 and 83,022,812 shares issued and 87,003,808 and 79,441,991 shares outstanding	8,701	7,944
Additional paid-in capital	—	—
Accumulated deficit	(88,373) (80,440)
Accumulated other comprehensive loss	(10,419) (3,677)
Less: 3,759,862 shares of common stock in treasury, at cost	(12,857) (12,857)
Total stockholders' deficiency	(102,948) (89,030)
Total liabilities and stockholders' deficiency	\$ 885,641	\$ 927,768

The accompanying notes are an integral part of the condensed consolidated financial statements.

VECTOR GROUP LTD. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues*	\$272,783	\$288,995	\$806,983	\$840,553
Expenses:				
Cost of goods sold*	203,749	227,863	615,682	664,113
Operating, selling, administrative and general expenses	25,841	23,277	73,734	69,142
Operating income	43,193	37,855	117,567	107,298
Other income (expenses):				
Interest expense	(25,906)	(25,421)	(78,667)	(75,431)
Change in fair value of derivatives embedded within convertible debt	6,040	4,386	(21,020)	13,248
Acceleration of interest expense related to debt conversion	(7,072)	—	(14,960)	(1,217)
Equity income from non-consolidated real estate businesses	12,874	6,496	20,969	17,597
Equity income (loss) on long-term investments	124	(1,699)	(1,205)	(1,090)
Gain on sale of investment securities available for sale	1,640	6,017	1,640	20,558
Gain on liquidation of long-term investments	—	2,221	—	25,832
Gain on sales of townhomes	—	10	—	3,722
Other, net	341	135	856	351
Income before provision for income taxes	31,234	30,000	25,180	110,868
Income tax expense	13,302	12,451	11,043	43,645
Net income	\$17,932	\$17,549	\$14,137	\$67,223
Per basic common share:				
Net income applicable to common shares	\$0.21	\$0.21	\$0.17	\$0.80
Per diluted common share:				
Net income applicable to common shares	\$0.21	\$0.20	\$0.16	\$0.78
Cash distributions and dividends declared per share	\$0.38	\$0.36	\$1.14	\$1.09

* Revenues and Cost of goods sold include excise taxes of \$126,389, \$141,473, \$379,281 and \$412,041, respectively.

The accompanying notes are an integral part of the condensed consolidated financial statements.

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VECTOR GROUP LTD. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (Dollars in Thousands, Except Per Share Amounts)
 Unaudited

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$17,932	\$17,549	\$14,137	\$67,223
Net unrealized gains (losses) on investment securities available for sale:				
Change in net unrealized gains (losses)	883	1,933	(13,386)	5,353
Net unrealized gains reclassified into net income	(1,640)	(6,017)	(1,640)	(20,558)
Net unrealized losses on investment securities available for sale	(757)	(4,084)	(15,026)	(15,205)
Net unrealized gains (losses) on long-term investments accounted for under the equity method	476	(1,549)	1,018	(3,002)
Net change in forward contracts	15	18	47	49
Net change in pension-related amounts	870	680	2,611	2,040
Other comprehensive income (loss)	604	(4,935)	(11,350)	(16,118)
Income tax effect on:				
Change in net unrealized gains (losses) on investment securities	(358)	(1,025)	5,435	(2,393)
Net unrealized gains reclassified into net income on investment securities	665	2,531	665	8,347
Change in unrealized long-term investments	(193)	629	(413)	1,212
Net unrealized gains reclassified into net income on long-term investments	—	—	—	—
Forward contracts	(6)	(5)	(19)	(19)
Pension-related amounts	(353)	(105)	(1,060)	(649)
Income tax (provision) benefit on other comprehensive income (loss)	(245)	2,025	4,608	6,498
Other comprehensive income (loss), net of tax	359	(2,910)	(6,742)	(9,620)
Comprehensive income	\$18,291	\$14,639	\$7,395	\$57,603

The accompanying notes are an integral part of the condensed consolidated financial statements.

VECTOR GROUP LTD. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIENCY
(Dollars in Thousands, Except Per Share Amounts)
Unaudited

	Common Stock		Additional Paid-In	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
	Shares	Amount	Capital	Deficit	Income	Stock	Total
Balance, December 31, 2011	79,441,991	\$ 7,944	\$ —	\$ (80,440)	\$ (3,677)	\$(12,857)	\$(89,030)
Net income	—	—	—	14,137	—	—	14,137
Pension-related minimum liability adjustments, net of income taxes	—	—	—	—	1,551	—	1,551
Forward contract adjustments, net of income taxes	—	—	—	—	28	—	28
Unrealized gain on long-term investment securities, accounted for under the equity method, net of income taxes	—	—	—	—	605	—	605
Change in net unrealized loss on investment securities, net of income taxes	—	—	—	—	(7,951)	—	(7,951)
Net unrealized gains reclassified into net income, net of income taxes	—	—	—	—	(975)	—	(975)
Unrealized loss on investment securities, net of income taxes	—	—	—	—	—	—	(8,926)
Total other comprehensive loss	—	—	—	—	—	—	(6,742)
Total comprehensive income	—	—	—	—	—	—	7,395
Distributions and dividends on common stock	—	—	(77,891)	(21,656)	—	—	(99,547)
Effect of stock dividend	4,142,378	414	—	(414)	—	—	—
Note conversion, net of income taxes	3,476,654	348	76,540	—	—	—	76,888
Exercise of employee stock options	15,314	2	138	—	—	—	140
Surrender of shares in connection with employee stock option exercise and restricted stock vesting	(72,529)	(7)	(1,269)	—	—	—	(1,276)
Tax benefit of employee stock options exercised	—	—	48	—	—	—	48
Amortization of deferred compensation	—	—	2,434	—	—	—	2,434
Balance, as of September 30, 2012	87,003,808	\$ 8,701	\$ —	\$ (88,373)	\$ (10,419)	\$(12,857)	\$(102,948)

The accompanying notes are an integral part of the condensed consolidated financial statements.

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VECTOR GROUP LTD. AND SUBSIDIARIES
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (Dollars in Thousands, Except Per Share Amounts)
 Unaudited

	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011	
Net cash provided by operating activities	\$97,245	\$64,015	
Cash flows from investing activities:			
Sale of investment securities	3,831	28,102	
Purchase of investment securities	(1,148)	(2,847))
Proceeds from sale or liquidation of long-term investments	72	66,190	
Purchase of long-term investments	(5,000)	(10,000))
Investments in non-consolidated real estate businesses	(22,467)	(7,201))
Distributions from non-consolidated real estate businesses	31,221	6,752	
Proceeds from sale of townhomes, net	—	19,629	
Increase in cash surrender value of life insurance policies	(831)	(717))
(Increase) decrease in restricted assets	(1,126)	738)
Issuance of notes receivable	(355)	(216))
Proceeds from sale of fixed assets	418	156	
Capital expenditures	(8,268)	(8,469))
Net cash (used in) provided by investing activities	(3,653)	92,117)
Cash flows from financing activities:			
Proceeds from debt issuance	14,018	2,823	
Deferred financing costs	(315)	—)
Repayments of debt	(15,440)	(3,522))
Borrowings under revolver	794,249	769,247	
Repayments on revolver	(809,567)	(804,957))
Dividends and distributions on common stock	(100,392)	(92,987))
Proceeds from exercise of employee stock options	140	1,029	
Tax benefit of employee stock options exercised	48	821	
Net cash used in financing activities	(117,259)	(127,546))
Net (decrease) increase in cash and cash equivalents	(23,667)	28,586)
Cash and cash equivalents, beginning of period	240,923	299,825	
Cash and cash equivalents, end of period	\$217,256	\$328,411	

The accompanying notes are an integral part of the condensed consolidated financial statements.

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation:

The condensed consolidated financial statements of Vector Group Ltd. (the “Company” or “Vector”) include the accounts of VGR Holding LLC (“VGR Holding”), Liggett Group LLC (“Liggett”), Vector Tobacco Inc. (“Vector Tobacco”), Liggett Vector Brands LLC (“Liggett Vector Brands”), New Valley LLC (“New Valley”) and other less significant subsidiaries. All significant intercompany balances and transactions have been eliminated.

Liggett and Vector Tobacco are engaged in the manufacture and sale of cigarettes in the United States. New Valley is engaged in the real estate business and is seeking to acquire additional operating companies and real estate properties.

The interim condensed consolidated financial statements of the Company are unaudited and, in the opinion of management, reflect all adjustments necessary (which are normal and recurring) to state fairly the Company's consolidated financial position, results of operations, comprehensive income and cash flows. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011 filed with the Securities and Exchange Commission. The consolidated results of operations for interim periods should not be regarded as necessarily indicative of the results that may be expected for the entire year.

Certain reclassifications have been made to the 2011 financial information to conform to the 2012 presentation.

(b) Distributions and Dividends on Common Stock:

The Company records distributions on its common stock as dividends in its condensed consolidated statement of stockholders' equity to the extent of retained earnings and accumulated paid-in capital. Any amounts exceeding retained earnings are recorded as a reduction to additional paid-in capital. Any amounts then exceeding accumulated paid-in capital are recorded as an increase to accumulated deficit.

(c) Earnings Per Share (“EPS”):

Information concerning the Company's common stock has been adjusted to give retroactive effect to the 5% stock dividend paid to Company stockholders on September 28, 2012 and September 29, 2011. The dividends were recorded at par value of \$414 and \$378 since the Company did not have retained earnings at September 30, 2012 and 2011, respectively. All per share amounts and references to share amounts have been updated to reflect the retrospective effect of the stock dividends.

Net income for purposes of determining basic EPS was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$17,932	\$17,549	\$14,137	\$67,223

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Income attributable to participating securities	(350)	(359)	(284)	(1,390)
Net income available to common stockholders	\$17,582		\$17,190		\$13,853		\$65,833	

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VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

Net income for purposes of determining diluted EPS was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$17,932	\$17,549	\$14,137	\$67,223
Expense attributable to 3.875% Variable Interest Senior Convertible Debentures	—	680	—	4,608
Expense attributable to 6.75% Variable Interest Senior Convertible Note	—	—	—	2,994
Income attributable to participating securities	(350)	(373)	(284)	(1,548)
Net income available to common stockholders	\$17,582	\$17,856	\$13,853	\$73,277

Basic and diluted EPS were calculated using the following shares:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Weighted-average shares for basic EPS	85,299,645	82,965,473	83,891,231	82,472,035
Plus incremental shares related to stock options and non-vested restricted stock	165,723	640,507	191,974	527,305
Plus incremental shares related to convertible debt	—	6,479,204	—	10,952,616
Weighted-average shares for fully diluted EPS	85,465,368	90,085,184	84,083,205	93,951,956

The following stock options, non-vested restricted stock and shares issuable upon the conversion of convertible debt were outstanding during the three and nine months ended September 30, 2012 and 2011 but were not included in the computation of diluted EPS because the effect was anti-dilutive.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Number of stock options	N/A	11,088	N/A	11,088
Weighted-average exercise price	N/A	\$22.70	N/A	\$22.70
Weighted-average shares of non-vested restricted stock	3,500	N/A	3,500	N/A
Weighted-average expense per share	17.12	N/A	17.12	N/A
Weighted-average number of shares issuable upon conversion of debt	15,929,565	11,701,241	17,316,315	7,660,326
Weighted-average conversion price	\$13.95	\$13.47	\$14.05	\$14.04

VECTOR GROUP LTD.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS – (Continued)

(Dollars in Thousands, Except Per Share Amounts)

Unaudited

(d) Fair Value of Derivatives Embedded within Convertible Debt:

The Company has estimated the fair market value of the embedded derivatives based principally on the results of a valuation model. The estimated fair value of the derivatives embedded within the convertible debt is based principally on the present value of future dividend payments expected to be received by the convertible debt holders over the term of the debt. The discount rate applied to the future cash flows is estimated based on a spread in the yield of the Company's debt when compared to risk-free securities with the same duration; thus, a readily determinable fair market value of the embedded derivatives is not available. The valuation model assumes future dividend payments by the Company and utilizes interest rates and credit spreads for secured to unsecured debt, unsecured to subordinated debt and subordinated debt to preferred stock to determine the fair value of the derivatives embedded within the convertible debt. The valuation also considers other items, including current and future dividends and the volatility of the Company's stock price. The range of estimated fair market values of the Company's embedded derivatives was between \$85,887 and \$89,106. The Company recorded the fair market value of its embedded derivatives at the midpoint of the inputs at \$87,466 as of September 30, 2012. At December 31, 2011, the range of estimated fair market values of the Company's embedded derivatives was between \$130,917 and \$136,182. The Company recorded the fair market value of its embedded derivatives at the midpoint of the inputs at \$133,500 as of December 31, 2011. The estimated fair market value of the Company's embedded derivatives could change significantly based on future market conditions. (See Note 4.)

(e) New Accounting Pronouncements:

In May 2011, the FASB issued amendments to disclosure requirements for common fair value measurement. These amendments, effective for the interim and annual periods beginning on or after December 15, 2011 (early adoption is prohibited), result in a common definition of fair value and common requirements for measurement of and disclosure requirements between U.S. GAAP and IFRS. Consequently, the amendments change some fair value measurement principles and disclosure requirements. This accounting guidance only impacted presentation and disclosures and did not have a material impact on the Company's condensed consolidated financial position, results of operations or cash flows.

In July 2012, the FASB issued amendments to the indefinite-lived intangible asset impairment guidance which provides an option for companies to use a qualitative approach to test indefinite-lived intangible assets for impairment if certain conditions are met. The amendments are effective for annual and interim indefinite-lived intangible asset impairment tests performed for fiscal years beginning after September 15, 2012 (early adoption is permitted). The implementation of the amended accounting guidance is not expected to have a material impact on the Company's consolidated financial position or results of operations.

2. INVENTORIES

Inventories consist of:

September 30, 2012	December 31, 2011
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Leaf tobacco	\$66,920	\$65,411
Other raw materials	3,877	3,831