HANDLEMAN CO /MI/
Form 10-Q
September 12, 2001

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 first quarter ended July 28, 2001 Commission File Number 1-7923

Handleman Company

(Exact name of registrant as specified in its charter)

MICHIGAN	38-1242806
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

500 KIRTS BOULEVARD TROY, MICHIGAN	48084-4142	Area Code 248 362-4400
(Address of principal executive offices)	(Zip code)	(Registrant's telephone numb

Indicate by checkmark 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 at least the past 90 days.

YES X NO _______

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

CLASS	DATE	SHARES OUTSTANDING
Common Stock - $.01 Par Value	September 5, 2001	26,817,966

HANDLEMAN COMPANY

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HANDLEMAN COMPANY
CONSOLIDATED STATEMENT OF INCOME
(UNAUDITED)
(amounts in thousands except per share data)

	Three Months (13 Weeks) Ended	
	July 28, 2001	July 29, 2000
Revenues	$ 261,115	$ 231,435
Costs and expenses:		
Direct product costs	200,483	173,350
Selling, general and administrative expenses	54,165	54,248
Interest expense, net	896	854
Income before income taxes and minority interest	5,571	2,983

Income tax expense	(3,620)	(1,299)
Minority interest	87	58
Net income	$ 2,038	$ 1,742
Net income per share		
Basic	$ 0.08	$ 0.06
Diluted	$ 0.08	$ 0.06
Weighted average number of shares outstanding during the period		
Basic	26,618	27,692
Diluted	26,841	27,898

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

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HANDLEMAN COMPANY
CONSOLIDATED BALANCE SHEET
(amounts in thousands except share data)

	July 28, 2001 (Unaudited)	April 2 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,842	$ 33,6
Accounts receivable, less allowance of $ 14,527 at July 28, 2001 and $16,336 at April 28, 2001, respectively, for the gross profit impact of estimated future returns	269,331	265,2
Merchandise inventories	154,030	113,3
Other current assets	15,095	19,7
Total current assets	440,298	431,9
Property and equipment:		
Land	1,233	1,2
Buildings and improvements	14,665	14,6
Display fixtures	36,570	34,6
Equipment, furniture and other	68,882	68,3
	121,350	118,7

Less accumulated depreciation	66,256	61,8
	55,094	56,8
Other assets, net	102,760	101,8
Total assets	$ 598,152	$ 590,6
LIABILITIES		
Current liabilities:		
Accounts payable	$ 197,791	$ 209,7
Debt, current portion	14,571	14,5
Accrued and other liabilities	28,510	44,7
Total current liabilities	240,872	269,1
Debt, non-current	82,662	53,0
Other liabilities	17,184	15,3
SHAREHOLDERS' EQUITY		
Preferred stock, $1.00 par value; 1,000,000 shares authorized; none issued	--	
Common stock, $.01 par value; 60,000,000 shares authorized; 26,688,000 and 26,540,000 shares issued at July 28, 2001 and April 28, 2001, respectively	267	2
Foreign currency translation adjustment	(7,183)	(7,4
Unearned compensation	(13)	(
Retained earnings	264,363	260,5
Total shareholders' equity	257,434	253,2
Total liabilities and shareholders' equity	$ 598,152	$ 590,6

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

HANDLEMAN COMPANY
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(UNAUDITED)
(amounts in thousands)

Three Months (13 Weeks) Ended July 28, 20

Common Stock

	Shares Issued	Amount	Foreign Currency Translation Adjustment	Unearned Compensation	R E
April 28, 2001	26,540	$ 265	($ 7,479)	($ 63)	$
Net income					
Adjustment for foreign currency translation			296		
Comprehensive income, net of tax					
Common stock issuances, net of forfeitures, in connection with employee benefit plans	148	2		50	
Tax benefit from exercise of stock options					
July 28, 2001	26,688	$ 267	($ 7,183)	($ 13)	$

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

HANDLEMAN COMPANY
CONSOLIDATED STATEMENT OF CASH FLOWS
(UNAUDITED)
(amounts in thousands)

	Three Months (13 Weeks) E	
	July 28, 2001	July 2 2000
Cash flows from operating activities:		
Net income	$ 2,038	$ 1,7
Adjustments to reconcile net income to net cash used by operating activities:		

Depreciation	4,327	4,0
Amortization of acquisition costs	863	8
Recoupment of license advances	2,408	1,5
Loss on disposal of property and equipment	78	3
(Increase) decrease in accounts receivable	(4,051)	48,1
(Increase) decrease in merchandise inventories	(40,682)	(23,1
(Increase) decrease in other operating assets	3,383	(1,2
Increase (decrease) in accounts payable	(11,975)	(45,6
Increase (decrease) in other operating liabilities	(13,237)	3,0
Total adjustments	(58,886)	(12,0
Net cash used by operating activities	(56,848)	(10,3
Cash flows from investing activities:		
Additions to property and equipment	(2,648)	(4,2
Proceeds from disposition of property and equipment	37	
License advances and acquired rights	(2,986)	(7,2
Net cash used by investing activities	(5,597)	(11,5
Cash flows from financing activities:		
Issuances of debt	1,419,759	254,6
Repayments of debt	(1,390,111)	(254,6
Other changes in shareholders' equity, net	1,011	1
Net cash provided from financing activities	30,659	1
Net decrease in cash and cash equivalents	(31,786)	(21,7
Cash and cash equivalents at beginning of period	33,628	27,5
Cash and cash equivalents at end of period	$ 1,842	$ 5,8

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. In the opinion of management, the accompanying consolidated balance sheet and consolidated statements of income, shareholders' equity and cash flows contain all adjustments, consisting only of normal recurring adjustments necessary to present fairly the financial position of the Company as of July 28, 2001, and the results of operations and changes in cash flows for the three months then ended. Because of the seasonal nature of the Company's business, sales and earnings results for the three months ended July 28, 2001 are not

necessarily indicative of what the results will be for the full year. The consolidated balance sheet as of April 28, 2001 included in this Form 10-Q was derived from the audited consolidated financial statements of the Company included in the Company's 2001 Annual Report on Form 10-K filed with the Securities and Exchange Commission. Reference should be made to the Company's Form 10-K for the year ended April 28, 2001.

2. At each balance sheet date, management evaluates the carrying value and remaining estimated lives of long-lived assets, including intangible assets, for potential impairment by considering several factors, including management's plans for future operations, recent operating results, market trends and other economic factors relating to the operation to which the assets apply. Recoverability of these assets is measured by a comparison of the carrying amount of such assets to the future undiscounted net cash flows expected to be generated by the assets. If such assets were deemed to be impaired as a result of this measurement, the impairment that would be recognized is measured by the amount by which the carrying amount of the assets exceed the fair value of the assets as determined on a discounted basis.

3. Statements of Financial Accounting Standards (SFAS) No. 141 "Business Combinations" and No. 142 "Goodwill and Other Intangible Assets" were approved by the Financial Accounting Standards Board effective June 30, 2001. SFAS No. 141 eliminates the pooling-of-interests method for business combinations initiated after June 30, 2001. SFAS No. 141 requires the use of the purchase method of accounting and provides criteria for the recognition of intangible assets separately from goodwill. SFAS No. 142 changes the accounting for goodwill and other intangible assets with indefinite lives from an amortization approach to a non-amortization (impairment) approach. SFAS No. 142 requires amortization of goodwill recorded in connection with previous business combinations to cease upon adoption of the Statement which is required for fiscal years beginning after December 15, 2001 (fiscal 2003 for the Company). The Company is currently evaluating the impact of the statements and has not yet determined what effect, if any, they might have on the consolidated financial position and results of operations of the Company.

4. The Company operates in two business segments: Handleman Entertainment Resources ("H.E.R.") is responsible for music category management and distribution operations, and North Coast Entertainment ("NCE") is responsible for the Company's proprietary operations, which include music, video and licensing operations.

The accounting policies of the segments are the same as those described in Note 1, "Accounting Policies," contained in the Company's Form 10-K for the year ended April 28, 2001. Segment data includes intersegment revenues, as well as a charge allocating corporate costs to the operating segments. The Company evaluates performance of its segments and allocates resources to them based on income before interest, income taxes and minority interest ("segment income").

The tables below present information about reported segments for the three months ended July 28, 2001 and July 29, 2000 (in thousands of dollars):

Three Months Ended July 28, 2001:	H.E.R.	NCE
Revenues, external customers	$239,442	$ 21,584
Intersegment revenues	--	3,823
Segment income	10,243	(4,043)
Total assets	518,714	178,266
Capital expenditures	1,737	911

Three Months Ended July 29, 2000:	H.E.R.	NCE
Revenues, external customers	$207,709	$ 23,726
Intersegment revenues	--	448
Segment income	5,993	(2,373)
Total assets	381,906	179,862
Capital expenditures	2,572	1,695

A reconciliation of total segment revenues to consolidated revenues, total segment income to total consolidated income before income taxes and minority interest, and total segment assets to consolidated assets as of and for the three months ended July 28, 2001 and July 29, 2000 is as follows (in thousands of dollars):

	July 28, 2001
Revenues	
Total segment revenues	$264,849
Corporate rental income	89
Elimination of intersegment revenues	(3,823)
Consolidated revenues	$261,115
Income Before Income Taxes and Minority Interest	
Total segment income for reportable segments	$ 6,200
Interest revenue	386
Interest expense	(1,282)
Unallocated corporate income	267

Consolidated income before income taxes and minority interest	$ 5,571

Assets

Total segment assets	$696,980
Elimination of intercompany receivables and payables	(98,828)
Total consolidated assets	$598,152

5. A reconciliation of the weighted average shares used in the calculation of basic and diluted shares is as follows (in thousands):

	Three Mon
	July 28, 2001
Weighted average shares during the period-basic	26,618
Additional shares from assumed exercise of stock options	223
Weighted average shares adjusted for assumed exercise of stock options-diluted	26,841

Handleman Company
Management's Discussion and Analysis of
Financial Condition and Results of Operations

Revenues for the first quarter of fiscal 2002 which ended July 28, 2001, increased 13% to $261.1 million from $231.4 million for the first quarter of fiscal 2001 which ended July 29, 2000. Net income for the first quarter of fiscal 2002 was $2.0 million, or $.08 per diluted share, compared to $1.7 million or $.06 per diluted share for the first quarter of fiscal 2001.

The Company has two business segments: Handleman Entertainment Resources ("H.E.R.") and North Coast Entertainment ("NCE"). H.E.R. consists of music category management and distribution operations in the United States, Canada, United Kingdom, Mexico and Brazil. NCE encompasses the Company's proprietary operations which include music, video and licensing operations.

H.E.R. net sales were $239.4 million for the first quarter of fiscal 2002, compared to $207.7 million for the first quarter of fiscal 2001, an increase of 15%. The increase in H.E.R. net sales for the first quarter of this year was generated by Handleman UK Limited which accounted for approximately 60% of the sales increase due to the commencement of category management, distribution and service to a new customer within the United Kingdom, and by H.E.R. United States operations which accounted for approximately 40% of the sales increase primarily due to new releases by top artists shipped during the first quarter of this year.

NCE net sales for the first quarter of this year were $25.4 million, compared to $24.2 million for the first quarter of last year, an increase of 5%. The higher net sales level this year was primarily due to the Madacy operating unit; net sales at the Anchor Bay Entertainment operating unit were up slightly over the prior year, while net sales at The itsy bitsy Entertainment Company ("TibECo") were lower versus the prior year.

Consolidated direct product costs as a percentage of revenues was 76.8% for the first quarter of fiscal 2002, compared to 74.9% for the first quarter of fiscal 2001. Consolidated direct product costs as a percentage of revenues this year was more in line with consolidated direct product costs as a percentage of revenues achieved during the last half of fiscal 2001.

Selling, general and administrative ("SG&A") expenses were $54.2 million for the first quarter of both this year and last year, in spite of the 13% increase in the Company's revenues, primarily due to an ongoing focus on expense control.

Income before interest, income taxes and minority interest ("operating income") for the first quarter ended July 28, 2001 was $6.5 million, compared to $3.8 million for the first quarter ended July 29, 2000. H.E.R. operating income increased 70% to $10.2 million for the first quarter of this year from $6.0 million for the comparable prior year period. The increase in H.E.R. operating income was primarily due to greater sales within the United States. NCE experienced an operating loss of $4.0 million for the first quarter of fiscal 2002, compared to an operating loss of $2.4 million for the first quarter of fiscal 2001. The increase in the NCE operating loss was due to a higher operating loss at TibECo, caused by several one-time costs incurred in the first quarter of this year. During the latter part of the first quarter of fiscal 2002, the Company took a more active role in managing the day-to-day operations at TibECo and has implemented certain expense controls.

The effective income tax rate for the first quarter of fiscal 2002 was 65.0%, compared to 43.5% for the first quarter of fiscal 2001. The higher rate this year was due to increased losses at TibECo, for which the Company could not recognize any tax benefit. The Company has recently restructured its TibECo shareholder agreement, and beginning with the second quarter of fiscal 2002, TibECo results will be included in the Company's tax return. Accordingly, the Company will be able to recognize a tax benefit in the event of future operating losses at TibECo.

On August 8, 2001, the Company replaced its $150 million revolving credit facility with an unsecured $170 million line of credit, arranged with a consortium of banks. This new agreement expires in August 2004. Management believes that with this new credit facility and with cash provided from operations, the Company will have sufficient liquidity to fund day-to-day operations including seasonal increases in inventory levels.

The Company's first quarter is traditionally its weakest quarter. The Company has historically generated the majority of its earnings in subsequent fiscal quarters. Management expects net sales for the second quarter of fiscal 2002 to increase in the low "teens," as a percent, over the second quarter of last year. This is predicated upon increased sales expected at Handleman UK Limited and current new releases by top artists scheduled for the second quarter of this year, but tempered by current expectations of overall music industry sales. Management believes direct product costs as a percentage of revenues will be similar to that achieved in the first quarter of this year. Management also expects a continuation of modest improvements in SG&A expenses as a percentage of revenues, on a quarter-to-quarter basis, during the remainder of fiscal 2002. The Company estimates the overall effective tax rate for the second quarter of fiscal 2002 to be in the 38% range. As a result of these above mentioned expectations, combined with less optimistic expectations for the overall music market, management anticipates net income will increase in the mid-to-upper single digits, as a percent, over the second quarter of last year.

Merchandise inventories at July 28, 2001 was $154.0 million, compared to $113.3 million at April 28, 2001. The increase in merchandise inventories was primarily due to increased inventory purchases to support the higher sales level anticipated in the second quarter of fiscal 2002.

Accounts payable at July 28, 2001 totaled $197.8 million, compared to $209.8 million at April 28, 2001. The decrease in accounts payable was chiefly due to the timing of payments to vendors.

Accrued and other liabilities decreased to $28.5 million at July 28, 2001 from $44.8 million at April 28, 2001. The decrease in accrued and other liabilities was primarily attributable to the timing of payments related to income taxes payable, accrued royalties and accrued bonuses.

Debt, non-current at July 28, 2001 was $82.7 million, compared to $53.0 million at April 28, 2001. The increase in debt, non-current was primarily due to the investment in working capital required to support the Company's growth.

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This document contains forward-looking statements that are not historical facts and involve risk and uncertainties. Actual results, events and performance could differ materially from those contemplated by these forward-looking statements, including, without limitations, conditions in the music industry, ability to enter into profitable agreements with customers in the new businesses outlined in the Company's strategic growth plan, securing funding or providing sufficient cash required to build and grow the new businesses, customer requirements, continuation of satisfactory relationships with existing customers and suppliers, nature and extent of new product releases, retail environment, effects of electronic commerce, relationships with the Company's lenders, pricing and competitive pressures, certain global and regional economic conditions, and other factors discussed in this Form 10-Q and those detailed from time to time in the Company's other filings with the Securities and Exchange Commission. The Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date of this document. Additional information that could cause actual results to differ materially from any forward-looking statements may be contained in the Company's Annual Report on Form 10-K.

PART II - OTHER INFORMATION

Item 6. Exhibits or Reports on Form 8-K

No reports on Form 8-K were filed during the quarter.

SIGNATURES: Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HANDLEMAN COMPANY

DATE: September 11, 2001 BY: /s/ Stephen Strome

STEPHEN STROME
Chairman and Chief
Executive Officer

DATE: September 11, 2001 BY: /s/ Thomas C. Braum, Jr.

THOMAS C. BRAUM, JR.
Senior Vice President,
Chief Financial Officer
(Principal Financial
Officer)