Houghton Mifflin Harcourt Co
Form 10-Q
May 07, 2015
Table of Contents

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 March 31, 2015

OR

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

Commission file number 001-36166

Houghton Mifflin Harcourt Company

(Exact name of registrant as specified in its charter)

Delaware	**27-1566372**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

222 Berkeley Street

Boston, MA 02116

(617) 351-5000

(Address, including zip code, and telephone number, including area code, of registrant s 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 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 x 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). Yes x 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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

The number of shares of common stock, par value $0.01 per share, outstanding as of April 30, 2015 was 143,420,477.

Table of Contents

		Page(s)
PART I. FINANCIAL INFORMATION		
Item 1.	Consolidated Financial Statements (Unaudited):	
	Consolidated Balance Sheets	4
	Consolidated Statements of Operations	5
	Consolidated Statements of Comprehensive Loss	6
	Consolidated Statements of Cash Flows	7
	Notes to Consolidated Financial Statements	8
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	31
Item 4.	Controls and Procedures	32
PART II. OTHER INFORMATION		
Item 1.	Legal Proceedings	32
Item 1A.	Risk Factors	33
Item 6.	Exhibits	33
SIGNATURES		35

Table of Contents

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein include forward-looking statements, which involve risks and uncertainties. These forward-looking statements can be identified by the use of forward-looking terminology, including the terms believes, estimates, projects, anticipates, expects, could, intends, may, will or should, forecast, intend, target or, in each case, their negative, or other variations or comparable terminology. These forward-looking statements include all matters that are not historical facts. They include statements regarding our intentions, beliefs or current expectations concerning, among other things, our results of operations, financial condition, liquidity, prospects, growth, strategies, the industry in which we operate, the proposed acquisition and its closing and impact, the proposed new term loan, and potential business decisions. We derive many of our forward-looking statements from our operating budgets and forecasts, which are based upon many detailed assumptions. While we believe that our assumptions are reasonable, we caution that it is very difficult to predict the impact of known factors, and, of course, it is impossible for us to anticipate all factors that could affect our actual results. All forward-looking statements are based upon information available to us on the date of this report.

By their nature, forward-looking statements involve risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. We caution you that forward-looking statements are not guarantees of future performance and that our actual results of operations, financial condition and liquidity, and the development of the industry in which we operate may differ materially from those made in or suggested by the forward-looking statements contained herein. In addition, even if our results of operations, financial condition and liquidity and the development of the industry in which we operate are consistent with the forward-looking statements contained herein, those results or developments may not be indicative of results or developments in subsequent periods.

Important factors that could cause our results to vary from expectations include, but are not limited to: changes in state and local education funding and/or related programs, legislation and procurement processes; adverse or worsening economic trends or the continuation of current economic conditions; changes in consumer demand for, and acceptance of, our products; changes in competitive factors; offerings by technology companies that compete with our products; industry cycles and trends; conditions and/or changes in the publishing industry; changes or the loss of our key third-party print vendors; restrictions under agreements governing our outstanding indebtedness; changes in laws or regulations governing our business and operations; changes or failures in the information technology systems we use; demographic trends; uncertainty surrounding our ability to enforce our intellectual property rights; inability to retain management or hire employees; impact of potential impairment of goodwill and other intangibles in a challenging economy; decline or volatility of our stock price regardless of our operating performance; inability or delay in closing acquisition; ability to obtain new term loan; ability to integrate the business; and other factors discussed in the Risk Factors section in this report and the Risk Factors section of our Annual Report on Form 10-K for the year ended December 31, 2014. In light of these risks, uncertainties and assumptions, the forward-looking events described herein may not occur.

We undertake no obligation, and do not expect, to publicly update or publicly revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as required by law. All subsequent written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained herein.

Table of Contents

PART 1 FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (Unaudited)

Houghton Mifflin Harcourt Company

Consolidated Balance Sheets (Unaudited)

(in thousands of dollars, except share information)	**March 31, 2015**	**December 31, 2014**
Assets		
Current assets		
Cash and cash equivalents	$ 562,037	$ 456,581
Short-term investments		286,764
Accounts receivable, net of allowance for bad debts and book returns of $29.4 million and $27.8 million, respectively	196,803	255,669
Inventories	213,445	183,961
Deferred income taxes		20,459
Prepaid expenses and other assets	21,131	18,665
Total current assets	993,416	1,222,099
Property, plant, and equipment, net	133,664	138,362
Pre-publication costs, net	232,198	236,995
Royalty advances to authors, net	47,498	46,777
Goodwill	532,921	532,921
Other intangible assets, net	775,608	801,969
Deferred income taxes	3,705	3,705
Other assets	23,519	28,279
Total assets	$ 2,742,529	$ 3,011,107
Liabilities and Stockholders Equity		
Current liabilities		
Current portion of long-term debt	$ 2,500	$ 67,500
Accounts payable	76,988	51,266
Royalties payable	55,935	80,089
Salaries, wages, and commissions payable	17,057	59,733
Deferred revenue	154,391	157,016
Interest payable	40	47
Severance and other charges	5,876	5,928
Accrued postretirement benefits	2,037	2,037
Other liabilities	37,650	27,015
Total current liabilities	352,474	450,631
Long-term debt	176,449	175,625

Long-term deferred revenue	357,985	370,103
Accrued pension benefits	17,826	18,525
Accrued postretirement benefits	25,844	26,500
Deferred income taxes	106,230	112,220
Other liabilities	95,513	97,823
Total liabilities	1,132,321	1,251,427
Commitments and contingencies (Note 11)		
Stockholders equity		
Preferred stock, $0.01 par value: 20,000,000 shares authorized; no shares issued and outstanding at March 31, 2015 and December 31, 2014		
Common stock, $0.01 par value: 380,000,000 shares authorized; 143,247,899 and 142,000,019 shares issued at March 31, 2015 and December 31, 2014, respectively, and 143,165,877 and 141,917,997 shares outstanding at March 31, 2015 and December 31, 2014, respectively	1,432	1,420
Treasury stock, 82,022 shares as of March 31, 2015 and December 31, 2014		
Capital in excess of par value	4,796,427	4,784,962
Accumulated deficit	(3,159,853)	(2,999,913)
Accumulated other comprehensive loss	(27,798)	(26,789)
Total stockholders equity	1,610,208	1,759,680
Total liabilities and stockholders equity	$ 2,742,529	$ 3,011,107

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

Table of Contents

Houghton Mifflin Harcourt Company

Consolidated Statements of Operations (Unaudited)

(in thousands of dollars, except share and per share information)	**Three Months Ended March 31, 2015**	**2014**
Net sales	$ 162,669	$ 153,933
Costs and expenses		
Cost of sales, excluding pre-publication and publishing rights amortization	96,569	92,648
Publishing rights amortization	23,143	30,751
Pre-publication amortization	26,463	28,974
Cost of sales	146,175	152,373
Selling and administrative	143,009	137,010
Other intangible asset amortization	3,218	2,945
Severance and other charges	1,057	1,757
Operating loss	(130,790)	(140,152)
Other income (expense)		
Interest expense	(5,954)	(4,297)
Change in fair value of derivative instruments	(2,220)	(103)
Loss before taxes	(138,964)	(144,552)
Income tax expense	20,976	1,783
Net loss	$ (159,940)	$ (146,335)
Net loss per share attributable to common stockholders		
Basic	$ (1.12)	$ (1.05)
Diluted	$ (1.12)	$ (1.05)
Weighted average shares outstanding		
Basic	142,364,327	139,982,297
Diluted	142,364,327	139,982,297

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

Table of Contents

Houghton Mifflin Harcourt Company

Consolidated Statements of Comprehensive Loss (Unaudited)

(in thousands of dollars)	**Three Months Ended March 31, 2015**	**2014**
Net loss	$ (159,940)	$ (146,335)
Other comprehensive (loss) income, net of taxes:		
Foreign currency translation adjustments	(1,009)	203
Unrealized gain on short-term investments		9
Other comprehensive (loss) income, net of taxes	(1,009)	212
Comprehensive loss	$ (160,949)	$ (146,123)

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

6

Table of Contents

Houghton Mifflin Harcourt Company

Consolidated Statements of Cash Flows (Unaudited)

(in thousands of dollars)	**Three Months Ended March 31, 2015**	**2014**
Cash flows from operating activities		
Net loss	$ (159,940)	$ (146,335)
Adjustments to reconcile net loss to net cash used in operating activities		
Depreciation and amortization expense	71,234	79,909
Amortization of deferred financing costs	3,209	1,188
Deferred income taxes	14,469	947
Stock-based compensation expense	3,095	2,397
Change in fair value of derivative instruments	2,220	103
Changes in operating assets and liabilities		
Accounts receivable	58,866	57,854
Inventories	(29,484)	(26,637)
Accounts payable and accrued expenses	(21,670)	(34,269)
Royalties, net	(24,875)	(21,112)
Deferred revenue	(14,743)	(9,443)
Interest payable	(7)	(7)
Severance and other charges	(1,116)	(1,769)
Accrued pension and postretirement benefits	(1,355)	(2,941)
Other, net	7,166	(2,429)
Net cash used in operating activities	(92,931)	(102,544)
Cash flows from investing activities		
Proceeds from sales and maturities of short-term investments	286,732	19,000
Purchases of short-term investments		(8,053)
Additions to pre-publication costs	(18,229)	(38,283)
Additions to property, plant, and equipment	(14,115)	(14,994)
Net cash provided by (used in) investing activities	254,388	(42,330)
Cash flows from financing activities		
Payments of long-term debt	(64,176)	(625)
Tax withholding payments related to net share settlements of restricted stock units	(124)	(366)
Proceeds from stock option exercises	8,299	
Net cash used in financing activities	(56,001)	(991)
Net increase (decrease) in cash and cash equivalents	105,456	(145,865)
Cash and cash equivalents		
Beginning of period	456,581	313,628

Net increase (decrease) in cash and cash equivalents	105,456	(145,865)
End of period	$ 562,037	$ 167,763
Supplementary disclosure of cash flow information		
Pre-publication costs included in accounts payable (noncash)	$ 9,798	$ 13,176
Property, plant, and equipment included in accounts payable (noncash)	3,396	3,136
Property, plant, and equipment acquired under capital leases (noncash)	2,980	4,272

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

Table of Contents

Houghton Mifflin Harcourt Company

Notes to Consolidated Financial Statements (Unaudited)

(in thousands of dollars, except share and per share information)

1. Basis of Presentation

Houghton Mifflin Harcourt Company (HMH , Houghton Mifflin Harcourt , we , us , our , or the Company) is a g learning company, specializing in education solutions across a variety of media, delivering content, services and technology to over 50 million students in over 150 countries worldwide. We deliver our offerings to both educational institutions and consumers around the world. In the United States, we are the leading provider of Kindergarten through twelfth grade (K-12) educational content by market share. We believe that nearly every current K-12 student in the United States has utilized our content during the course of his or her education. As a result, we believe that we have an established reputation with students and educators that is difficult for others to replicate and positions us to also provide broader content and services to serve their learning needs beyond the classroom. We believe our long-standing reputation and well-known brands enable us to capitalize on consumer and digital trends in the education market through our existing and developing channels. Furthermore, since 1832, we have published trade and reference materials, including adult and children s fiction and non-fiction books that have won industry awards such as the Pulitzer Prize, Newbery and Caldecott medals and National Book Award, all of which are widely known.

The consolidated financial statements of HMH include the accounts of all of our wholly-owned subsidiaries as of March 31, 2015 and December 31, 2014 and the three month periods ended March 31, 2015 and March 31, 2014.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. Certain information and note disclosures normally included in our annual financial statements prepared in accordance with GAAP have been condensed or omitted consistent with Article 10 of Regulation S-X. In the opinion of management, our unaudited consolidated financial statements and accompanying notes include all adjustments (consisting of normal recurring adjustments) considered necessary by management to fairly state the results of operations, financial position and cash flows for the interim periods presented. Interim results of operations are not necessarily indicative of the results for the full year or for any future period. These financial statements should be read in conjunction with the annual financial statements and the notes thereto also included therein.

During the first quarter of 2014, we recorded an out-of-period correction of approximately $1.1 million reducing net sales and increasing deferred revenue that should have been deferred previously. In addition, during the first quarter of 2014, we recorded approximately $3.5 million of incremental expense, primarily commissions, related to the prior year. These out-of-period corrections had no impact on our debt covenant compliance. Management believes these out-of-period corrections are not material to the current period financial statements or any previously issued financial statements.

Seasonality and Comparability

Our net sales, operating profit and operating cash flows are impacted by the inherent seasonality of the academic calendar. Consequently, the performance of our businesses may not be comparable quarter to consecutive quarter and should be considered on the basis of results for the whole year or by comparing results in a quarter with results in the

same quarter for the previous year.

Schools make most of their purchases in the second and third quarters of the calendar year in preparation for the beginning of the school year. Thus, over the past three years, approximately 67% of consolidated net sales have historically been realized in the second and third quarters. Sales of K-12 instructional materials and customized testing products are also cyclical, with some years offering more sales opportunities than others. The amount of funding available at the state level for educational materials also has a significant effect on year-to-year net sales. Although the loss of a single school customer would not have a material adverse effect on our business, schedules of school adoptions and market acceptance of our products can materially affect year-to-year net sales performance.

2. Significant Accounting Policies and Estimates

Our financial results are affected by the selection and application of accounting policies and methods. There were no material changes in the three months ended March 31, 2015 to the application of significant accounting policies and estimates as described in our audited financial statements for the year ended December 31, 2014.

Table of Contents

3. Recent Accounting Pronouncements

Recent accounting pronouncements not included below, are not expected to have a material impact on our consolidated financial position and results of operations.

In April 2015, the Financial Accounting Standards Board (FASB) issued new accounting guidance related to simplifying the presentation of debt issuance costs. This standard amends existing guidance to require the presentation of debt issuance costs in the balance sheet as a deduction from the carrying amount of the related debt liability instead of a deferred charge, consistent with debt discounts. It is effective for annual reporting periods beginning after December 15, 2015, but early adoption is permitted. We are in the process of evaluating the impact the adoption of this standard will have on our consolidated financial statements and footnote disclosures.

In April 2015, the FASB proposed deferring the effective date of the new accounting guidance related to revenue recognition by one year to December 15, 2017 for annual reporting periods beginning after that date. The FASB also proposed permitting early adoption of the standard, but not before the original effective date of December 15, 2016. We are in the process of evaluating the impact that the adoption of this new revenue recognition standard issued in May 2014 will have on our consolidated financial statements and footnote disclosures.

In May 2014, the FASB issued new accounting guidance related to revenue recognition. This new standard will replace all current U.S. GAAP guidance on this topic and eliminate all industry-specific guidance. The new revenue recognition standard provides a unified model to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration for which the entity expects to be entitled in exchange for those goods or services. This guidance will be effective beginning January 1, 2017 and can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption.

4. Inventories

Inventories consisted of the following:

	March 31, 2015	December 31, 2014
Finished goods	$ 201,016	$ 178,812
Raw materials	12,429	5,149
Inventory	$ 213,445	$ 183,961

5. Goodwill and Other Intangible Assets

Goodwill and other intangible assets consisted of the following:

March 31, 2015	December 31, 2014
Cost	Cost

		Accumulated Amortization		Accumulated Amortization
Goodwill	$ 532,921	$	$ 532,921	$
Trademarks and trade names	439,605		439,605	
Publishing rights	1,180,000	(912,703)	1,180,000	(889,560)
Customer related and other	283,340	(214,634)	283,340	(211,416)
	$ 2,435,866	$ (1,127,337)	$ 2,435,866	$ (1,100,976)

Amortization expense for publishing rights and customer related and other intangibles were $26.4 million and $33.7 million for the three months ended March 31, 2015 and 2014, respectively.

6. Debt

Our debt consisted of the following:

	March 31, 2015	December 31, 2014
$250,000 term loan due May 21, 2018 interest payable monthly	$ 178,949	$ 243,125
Less: Current portion of long-term debt	2,500	67,500
Total long-term debt	$ 176,449	$ 175,625

In accordance with the Excess Cash Flow provisions of the Term Loan Facility, which are predicated upon our leverage ratio and cash flow, we made a $63.6 million principal payment on March 5, 2015. In connection with this principal payment, we recorded a $2.0 million write off of deferred financing costs, which was recognized as interest expense in the consolidated statements of operations for the three months ended March 31, 2015. In connection with the Excess Cash Flow payment, $1.5 million was reclassified from current portion of long-term debt to long-term debt as of March 31, 2015.

On January 15, 2014, we entered into Amendment No. 4 to our term loan facility, which reduced the interest rate applicable to outstanding borrowings by 1.0%. The transaction was accounted for under the accounting guidance for debt modifications and extinguishments. We recorded an expense of approximately $1.0 million relating to third party transaction fees which was included in the selling and administrative line item in its consolidated statements of operations for the three months ended March 31, 2014.

Loan Covenants

We are required to meet certain restrictive financial covenants as defined under our term loan facility and revolving credit facility. We have financial covenants pertaining to interest coverage, maximum leverage, and fixed charge ratios. The interest coverage ratio is 9.0 to 1.0 for all fiscal quarters ending through maturity. The maximum leverage ratio is 2.0 to 1.0 for all fiscal quarters ending through maturity. The fixed charge ratio, which only pertains to the revolving credit facility and is only tested in limited situations, is 1.0 to 1.0 through the end of the facility. As of March 31, 2015, we were in compliance with all of our debt covenants.

Loan Guarantees

Under both the revolving credit facility and the term loan facility, Houghton Mifflin Harcourt Publishers Inc., HMH Publishers LLC and Houghton Mifflin Harcourt Publishing Company are the borrowers (collectively, the Borrowers), and Citibank, N.A. acts as both the administrative agent and the collateral agent.

The obligations under our senior secured credit facilities are guaranteed by the Company and each of its direct and indirect for-profit domestic subsidiaries (other than the Borrowers) (collectively, the Guarantors) and are secured by all capital stock and other equity interests of the Borrowers and the Guarantors and substantially all of the other tangible and intangible assets of the Borrowers and the Guarantors, including, without limitation, receivables, inventory, equipment, contract rights, securities, patents, trademarks, other intellectual property, cash, bank accounts and securities accounts and owned real estate. The revolving credit facility is secured by first priority liens on receivables, inventory, deposit accounts, securities accounts, instruments, chattel paper and other assets related to the

foregoing (the Revolving First Lien Collateral), and second priority liens on the collateral which secures the term loan facility on a first priority basis. The term loan facility is secured by first priority liens on the capital stock and other equity interests of the Borrowers and the Guarantors, equipment, owned real estate, trademarks and other intellectual property, general intangibles that are not Revolving First Lien Collateral and other assets related to the foregoing, and second priority liens on the Revolving First Lien Collateral.

7. Severance and Other Charges

2015

During the three months ended March 31, 2015, $1.0 million of severance payments were made to employees whose employment ended in 2015 and prior years and $1.2 million of net payments for office space no longer utilized by the Company. Further, we recorded an expense in the amount of $1.0 million to reflect additional costs for severance, which we expect to be paid over the next twelve months.

Table of Contents

2014

During the three months ended March 31, 2014, $2.4 million of severance payments were made to employees whose employment ended in 2014 and prior years and $1.1 million of net payments for office space no longer utilized by the Company. Further, we recorded an expense in the amount of $1.8 million to reflect additional costs for severance.

A summary of the significant components of the severance/restructuring and other charges is as follows:

	2015			
	Severance/ restructuring accrual at December 31, 2014	Severance/ restructuring expense	Cash payments	Severance/ restructuring accrual at March 31, 2015
Severance costs	$ 1,271	$ 1,028	$ (984)	$ 1,315
Other accruals	9,050	29	(1,188)	7,891
	$ 10,321	$ 1,057	$ (2,172)	$ 9,206

	2014			
	Severance/ restructuring accrual at December 31, 2013	Severance/ restructuring expense	Cash payments	Severance/ restructuring accrual at March 31, 2014
Severance costs	$ 4,115	$ 1,757	$ (2,442)	$ 3,430
Other accruals	11,416		(1,084)	10,332
	$ 15,531	$ 1,757	$ (3,526)	$ 13,762

The current portion of severance and other charges was $5.9 million as of March 31, 2015 and December 31, 2014.

8. Income Taxes

The computation of the annual estimated effective tax rate at each interim period requires certain estimates and significant judgment, including, but not limited to, the expected operating income for the year, projections of the proportion of income earned and taxed in various jurisdictions, permanent and temporary differences and the likelihood of recovering deferred tax assets generated in the current year. The accounting estimates used to compute the provision for income taxes may change as new events occur, more experience is acquired, additional information is obtained or as the tax environment changes.

At the end of each interim period, we estimate the annual effective tax rate and apply that rate to our ordinary quarterly earnings. The amount of interim tax benefit recorded for the year-to-date ordinary loss is limited to the

amount that is expected to be realized during the year or recognizable as a deferred tax asset at year end. The tax expense or benefit related to significant, unusual or extraordinary items that will be separately reported or reported net of their related tax effect, are individually computed, and are recognized in the interim period in which those items occur. In addition, the effect of changes in enacted tax laws or rates or tax status is recognized in the interim period in which the change occurs.

For the three months ended March 31, 2015, our annual effective tax rate, exclusive of discrete items used to calculate the tax provision, is expected to be approximately 14.0%. For the three months ended March 31, 2014, the annual effective tax rate method was limited to the amount that is expected to be realized during the year or recognizable as a deferred tax asset at year end.

For the three months ended March 31, 2015 and 2014, we recorded an income tax expense of approximately $21.0 million and $1.8 million, respectively. For both periods, the income tax expense was impacted by certain discrete tax items including the accrual of potential interest and penalties on uncertain tax positions. The interim effective tax rate inclusive of discrete items was 15.1% and 1.2% for the three months ended March 31, 2015 and 2014, respectively.

Reserves for unrecognized tax benefits, excluding accrued interest, were $63.2 million at March 31, 2015 and December 31, 2014, and included in other long-term liabilities in the accompanying consolidated balance sheets.

9. Retirement and Postretirement Benefit Plans

We have a noncontributory, qualified defined benefit pension plan (the Retirement Plan), which covers certain employees. The Retirement Plan is a cash balance plan, which accrues benefits based on pay, length of service, and interest. The funding policy is to contribute amounts subject to minimum funding standards set forth by the Employee Retirement Income Security

Act of 1974 and the Internal Revenue Code. The Retirement Plan s assets consist principally of common stocks, fixed income securities, investments in registered investment companies, and cash and cash equivalents. We also have a nonqualified defined benefit plan, or nonqualified plan, that previously covered employees who earned over the qualified pay limit as determined by the Internal Revenue Service. The nonqualified plan accrues benefits for the participants based on the cash balance plan calculation. The nonqualified plan is not funded. We use a December 31 date to measure the pension and postretirement liabilities. In 2007, both the qualified and nonqualified pension plans eliminated participation in the plans for new employees hired after October 31, 2007.

We also had a foreign defined benefit plan. On May 28, 2014, the plan was converted to individual annuity policies and the liability discharge occurred.

We are required to recognize the funded status of defined benefit pension and other postretirement plans as an asset or liability in the balance sheet and are required to recognize actuarial gains and losses and prior service costs and credits in other comprehensive income and subsequently amortize those items in the statement of operations. Further, we are required to use a measurement date equal to the fiscal year-end.

Net periodic benefit cost (credit) for our pension and other postretirement benefits plans consisted of the following:

	Pension Plans Three Months Ended March 31,	
	2015	**2014**
Interest cost	$ 1,680	$ 2,088
Expected return on plan assets	(2,439)	(2,701)
Amortization of net loss	83	2
Net periodic benefit (credit) cost	$ (676)	$ (611)

	Other Post Retirement Plans Three Months Ended March 31,	
	2015	**2014**
Service cost	$ 51	$ 45
Interest cost	270	296
Amortization of prior service cost	(345)	(345)
Amortization of net loss	55	
Net periodic benefit cost (credit)	$ 31	$ (4)

There were no contributions to the pension plans for the three months ended March 31, 2015. Contributions to the pension plans for the three months ended March 31, 2014 were $2.0 million.

We do not expect to make a contribution to the pension plans during 2015.

10. Fair Value Measurements

The accounting standard for fair value measurements, among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. The accounting standard establishes a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows:

Level 1 Observable input such as quoted prices in active markets for identical assets or liabilities;

Level 2 Observable inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and

Level 3 Unobservable inputs in which there is little or no market data, which require the reporting entity to develop its own assumptions.

Assets and liabilities measured at fair value are based on one or more of three valuation techniques identified in the tables below. Where more than one technique is noted, individual assets or liabilities were valued using one or more of the noted techniques. The valuation techniques are as follows:

(a) Market approach: Prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities;

(b) Cost approach: Amount that would be currently required to replace the service capacity of an asset (current replacement cost); and

(c) Income approach: Valuation techniques to convert future amounts to a single present amount based on market expectations (including present value techniques).

On a recurring basis, we measure certain financial assets and liabilities at fair value, including our money market funds, short-term investments which consist of U.S. treasury securities and U.S. agency securities, and foreign exchange forward and option contracts. The accounting standard for fair value measurements defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. In determining fair value, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible as well as consider counterparty and its credit risk in its assessment of fair value.

Financial Assets and Liabilities

The following tables present our financial assets and liabilities measured at fair value on a recurring basis at March 31, 2015 and December 31, 2014:

	March 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Valuation Technique
Financial assets				
Money market funds	$ 540,410	$ 540,410	$	(a)
	$ 540,410	$ 540,410	$	
Financial liabilities				
Foreign exchange derivatives	$ 1,900	$	$ 1,900	(a)
	$ 1,900	$	$ 1,900	

	December 31, 2014	Quoted Prices in Active	Significant Other	Valuation Technique

			Markets for Identical Assets (Level 1)		Observable Inputs (Level 2)	
Financial assets						
Money market funds	$	438,907	$ 438,907	$		(a)
U.S. treasury securities		93,004	93,004			(a)
U.S. agency securities		194,028			194,028	(a)
	$	725,939	$ 531,911	$	194,028	
Financial liabilities						
Foreign exchange derivatives	$	1,370	$	$	1,370	(a)
	$	1,370	$	$	1,370	

Our money market funds and U.S. treasury securities are classified within Level 1 of the fair value hierarchy because they are valued using quoted prices in active markets for identical instruments. Our U.S. agency securities are classified within level 2 of the fair value hierarchy because they are valued using other than quoted prices in active markets. In addition to $540.4 million and $438.9 million invested in money market funds as of March 31, 2015 and December 31, 2014, respectively, we had $21.6 million and $17.7 million of cash invested in bank accounts as of March 31, 2015 and December 31, 2014, respectively.

Our foreign exchange derivatives consist of forward and option contracts and are classified within Level 2 of the fair value hierarchy because they are valued based on observable inputs and are available for substantially the full term of our derivative instruments. We use foreign exchange forward and option contracts to fix the functional currency value of forecasted commitments, payments and receipts. The aggregate notional amount of the outstanding foreign exchange forward and option contracts was $9.5 million and $18.7 million at March 31, 2015 and December 31, 2014, respectively. Our foreign exchange forward and option contracts contain netting provisions to mitigate credit risk in the event of counterparty default, including payment default and cross default. At March 31, 2015 and December 31, 2014, the fair value of our counterparty default exposure was less than $1.0 million and spread across several highly rated counterparties.

Table of Contents

Non-Financial Assets and Liabilities

There were no impairments related to our non-financial assets and there were no non-financial liabilities measured at fair value on a non-recurring basis during 2015.

The following table presents our nonfinancial assets and liabilities measured at fair value on a nonrecurring basis during 2014:

	December 31, 2014	Significant Unobservable Inputs (Level 3)	Total Impairment	Valuation Technique
Nonfinancial assets				
Investment in preferred stock	$	$	$ 1,279	(b)
Other intangible assets	3,800	3,800	400	(a)(c)
	$ 3,800	$ 3,800	$ 1,679	

Our nonfinancial assets, which include goodwill, other intangible assets, property, plant, and equipment, and pre-publication costs, are not required to be measured at fair value on a recurring basis. However, if certain trigger events occur, or if an annual impairment test is required, we evaluate the nonfinancial assets for impairment. If an impairment did occur, the asset is required to be recorded at the estimated fair value. An impairment analysis was not performed as there were no triggering events for the three months ended March 31, 2015.

Fair Value of Debt

The following table presents the carrying amounts and estimated fair market values of our debt at March 31, 2015 and December 31, 2014. The fair value of debt is deemed to be the amount at which the instrument could be exchanged in an orderly transaction between market participants at the measurement date.

	March 31, 2015		December 31, 2014	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Debt				
$250,000 term loan	$ 178,949	$ 178,949	$ 243,125	$ 242,517

The fair market values of our debt were estimated based on quoted market prices on a private exchange for those instruments that are traded and are classified as level 2 within the fair value hierarchy, at March 31, 2015 and December 31, 2014. The fair market values require varying degrees of management judgment. The factors used to estimate these values may not be valid on any subsequent date. Accordingly, the fair market values of the debt presented may not be indicative of their future values.

11. Commitments and Contingencies
Contingencies

We are involved in ordinary and routine litigation and matters incidental to our business. Litigation alleging infringement of copyrights and other intellectual property rights has become extensive in the educational publishing industry. Specifically, there have been various settled, pending and threatened litigation that allege we exceeded the print run limitation or other restrictions in licenses granted to us to reproduce photographs in our textbooks. While management believes that there is a reasonable possibility we may incur a loss associated with the pending and threatened litigation, we are not able to estimate such amount, but we do not expect any of these matters to have a material adverse effect on our results of operations, financial position or cash flows. We have insurance over such amounts and with coverage and deductibles as management believes is reasonable. There can be no assurance that our liability insurance will cover all events or that the limits of coverage will be sufficient to fully cover all liabilities. We were contingently liable for $12.4 million and $11.3 million of performance-related surety bonds for our operating activities as of March 31, 2015 and December 31, 2014, respectively. An aggregate of $21.1 million and $20.2 million of letters of credit existed as of March 31, 2015 and December 31, 2014, respectively, of which $2.4 million backed the aforementioned performance-related surety bonds as of March 31, 2015 and December 31, 2014, respectively.

We routinely enter into standard indemnification provisions as part of license agreements involving use of our intellectual property. These provisions typically require us to indemnify and hold harmless licensees in connection with any infringement claim by a third party relating to the intellectual property covered by the license agreement. The assessment business routinely

Table of Contents

enters into contracts with customers that contain provisions requiring us to indemnify the customer against a broad array of potential liabilities resulting from any breach of the contract or the invalidity of the test. Although the term of these provisions and the maximum potential amounts of future payments we could be required to make is not limited, we have never incurred any costs to defend or settle claims related to these types of indemnification provisions. We therefore believe the estimated fair value of these provisions is inconsequential, and have no liabilities recorded for them as of March 31, 2015 and December 31, 2014.

Concentration of Credit Risk and Significant Customers

As of March 31, 2015, one customer represented approximately $21.3 million, or 10.8%, of our accounts receivable, net balance. As of December 31, 2014, no individual customer comprised more than 10% of our accounts receivable, net balance. We believe that our accounts receivable credit risk exposure is limited and we have not experienced significant write-downs in our accounts receivable balances.

12. Net Loss Per Share

The following table sets forth the computation of basic and diluted earnings per share (EPS):

	Three Months Ended March 31,	
	2015	**2014**
Numerator		
Net loss attributable to common stockholders	$ (159,940)	$ (146,335)
Denominator		
Weighted average shares outstanding		
Basic	142,364,327	139,982,297
Diluted	142,364,327	139,982,297
Net loss per share attributable to common stockholders		
Basic	$ (1.12)	$ (1.05)
Diluted	$ (1.12)	$ (1.05)

As we incurred a net loss in each of the periods presented above, the outstanding stock options, restricted stock, and restricted stock units have an anti-dilutive effect and therefore are excluded from the computation of diluted weighted average shares outstanding. Accordingly, basic and diluted weighted average shares outstanding are equal for such periods.

The following table summarizes our weighted average outstanding common stock equivalents that were anti-dilutive due to the net loss attributable to common stockholders during the periods, and therefore excluded from the computation of diluted EPS:

	Three Months Ended March 31,

	2015	2014
Stock options	10,147,018	12,286,997
Restricted stock and restricted stock units	382,801	296,752

13. Segment Reporting

As of March 31, 2015, we had two reportable segments (Education and Trade Publishing). Our Education segment provides educational products, technology platforms and services to meet the diverse needs of today s classrooms. These products and services include print and digital content in the form of textbooks, digital courseware, instructional aids, educational assessment and intervention solutions, which are aimed at improving achievement and supporting learning for students that are not keeping pace with peers, professional development and school reform services. Our Trade Publishing segment primarily develops, markets and sells consumer books in print and digital formats and licenses book rights to other publishers and electronic businesses in the United States and abroad. The principal markets for Trade Publishing products are retail stores, both physical and online, and wholesalers. Reference materials are also sold to schools, colleges, libraries, office supply distributors and other businesses.

Table of Contents

We measure and evaluate our reportable segments based on net sales and segment Adjusted EBITDA. We exclude from our segments certain corporate-related expenses, as our corporate functions do not meet the definition of a segment, as defined in the accounting guidance relating to segment reporting. In addition, certain transactions or adjustments that our Chief Operating Decision Maker considers to be non-operational, such as amounts related to goodwill and other intangible asset impairment charges, restructuring-related charges, stock-based compensation charges, as well as amortization and depreciation expenses, are excluded from segment Adjusted EBITDA. Although we exclude these amounts from segment Adjusted EBITDA, they are included in reported consolidated net loss and are included in the reconciliation below.

(in thousands)	Three Months Ended March 31,			Total
	Education	Trade Publishing	Corporate/ Other	
2015				
Net sales	$ 128,870	$ 33,799	$	$ 162,669
Segment Adjusted EBITDA	(37,347)	(1,140)	(13,334)	(51,821)
2014				
Net sales	$ 121,874	$ 32,059	$	$ 153,933
Segment Adjusted EBITDA	(40,227)	(1,318)	(11,650)	(53,195)

Reconciliation of Segment Adjusted EBITDA to the consolidated statements of operations is as follows:

(in thousands)	Three Months Ended March 31,	
	2015	2014
Total Segment Adjusted EBITDA	$ (51,821)	$ (53,195)
Interest expense	(5,954)	(4,297)
Depreciation expense	(18,409)	(17,239)
Amortization expense	(52,824)	(62,670)
Stock-based compensation expense	(3,095)	(2,397)
Loss on derivative instruments	(2,220)	(103)
Purchase accounting adjustments	(197)	(575)
Fees, expenses or charges for equity offerings, debt or acquisitions	(3,377)	(2,114)
Restructuring	(10)	(205)
Severance, separation costs and facility closures	(1,057)	(1,757)
Loss before taxes	(138,964)	(144,552)
Provision for income taxes	20,976	1,783
Net loss	$ (159,940)	$ (146,335)

14. Subsequent Events

Stock and Asset Purchase Agreement

On April 23, 2015, we entered into a stock and asset purchase agreement with Scholastic Corporation (Scholastic) under which we would acquire the assets (including the stock of two of Scholastic s subsidiaries) comprising the Educational Technology and Services (EdTech) business of Scholastic. HMH will pay to Scholastic an aggregate purchase price of $575.0 million, subject to adjustments for working capital. $34.5 million of the purchase price would be deposited into an escrow account to be held for 18 months as security for potential indemnification obligations of Scholastic. Portions of such escrow will be released periodically during the 18-month period upon fulfillment of certain service levels under a transition services agreement to be entered into by Scholastic and HMH for the provision of certain transition support services by Scholastic and HMH after the closing. Subject to certain limitations, either HMH or Scholastic may terminate the acquisition if it has not been consummated by August 21, 2015. A termination of the acquisition under certain circumstances would entitle Scholastic to receive from HMH a termination fee in an amount equal to approximately $28.8 million.

The transaction is expected to close in the second calendar quarter of 2015, subject to closing conditions and regulatory approval. The acquisition is not subject to any financing conditions. There can be no assurance as to when the closing conditions will be satisfied, if at all.

Table of Contents

The acquisition would provide us with a leading position in intervention curriculum and services and extend our product offerings in key growth areas, including educational technology, early learning, and education services, creating a more comprehensive offering for students, teachers and schools. The acquisition would provide added digital infrastructure and expertise to support the continued development of next-generation products for HMH s pre-K-12 and consumer businesses.

Revolving Credit Facility Amendment

On April 23, 2015, we entered into Amendment No. 3 to our revolving credit facility. Amendment No. 3 permits us to increase the aggregate amount of indebtedness we may incur under our term loan agreement to $500.0 million, plus the aggregate amount of any incremental facilities provided for therein. We expect to seek an additional amendment that will permit us to increase the aggregate amount of indebtedness we may incur under our term loan agreement to $800.0 million, plus the aggregate amount of any incremental facilities provided for therein. No funds have been drawn on the revolving credit facility as of May 7, 2015.

Share Repurchase Program

Effective April 23, 2015, our board of directors authorized an additional $100.0 million under our existing share repurchase program, bringing the total authorization to $200.0 million. Additionally, on May 6, 2015, our board of directors authorized an incremental $300.0 million under our existing share repurchase program, bringing the total aggregate authorization to $500.0 million. The $300.0 million increase in authorization is conditional upon the successful increase in our term loan facility. The aggregate share repurchase program may be executed over a period of two years from May 6, 2015. Repurchases under the program may be made from time to time in open market or privately negotiated transactions. The extent and timing of any such repurchases would generally be at our discretion and subject to market conditions, applicable legal requirements and other considerations.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of the financial condition and results of operations of HMH should be read in conjunction with the interim unaudited consolidated financial statements and the related notes thereto included elsewhere in this Quarterly Report on Form 10-Q and the audited financial statements and the related notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2014, which was filed with the Securities Exchange Commission (the SEC) on February 26, 2015. This Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934, as amended. See Special Note Regarding Forward-Looking Statements included elsewhere in this Quarterly Report on Form 10-Q.

Overview

We are a global learning company, specializing in education solutions across a variety of media. We deliver content, services and technology to both educational institutions and consumers, reaching over 50 million students in more than 150 countries worldwide. In the United States, we are the leading provider of K-12 educational content by market share. Furthermore, since 1832, we have published trade and reference materials, including adult and children s fiction and non-fiction books that have won industry awards such as the Pulitzer Prize, Newbery and Caldecott medals and National Book Award, all of which we believe are widely known. We believe our long-standing reputation and well-known brands enable us to capitalize on consumer and digital trends in the education market through our existing and developing channels.

Corporate History

Houghton Mifflin Harcourt Company was incorporated as a Delaware corporation on March 5, 2010, and was established as the holding company of the current operating group. Houghton Mifflin Harcourt was formed in December 2007 with the acquisition of Harcourt Education Group, then the second-largest K-12 U.S. publisher, by Houghton Mifflin Group. We are headquartered in Boston, Massachusetts.

Recent Developments

The following recent developments occurred subsequent to the period covered by this report:

Stock and Asset Purchase Agreement

On April 23, 2015, we entered into a stock and asset purchase agreement with Scholastic Corporation (Scholastic) under which we would acquire the assets (including the stock of two of Scholastic s subsidiaries) comprising the Educational Technology and Services (EdTech) business of Scholastic. HMH will pay to Scholastic an aggregate purchase price of $575.0 million, subject to adjustments for working capital. $34.5 million of the purchase price would be deposited into an escrow account to be held for 18 months as security for potential indemnification obligations of Scholastic. Portions of such escrow will be released periodically during the 18-month period upon fulfillment of certain service levels under a transition services agreement to be entered into by Scholastic and HMH for the provision of certain transition support services by Scholastic and HMH after the closing. Subject to certain limitations, either HMH or Scholastic may terminate the acquisition if it has not been consummated by August 21, 2015. A termination of the acquisition under certain circumstances would entitle Scholastic to receive from HMH a termination fee in an amount equal to approximately $28.8 million.

The transaction is expected to close in the second calendar quarter of 2015, subject to closing conditions and regulatory approval. The acquisition is not subject to any financing conditions. There can be no assurance as to when the closing conditions will be satisfied, if at all.

The acquisition would provide us with a leading position in intervention curriculum and services and extend our product offerings in key growth areas, including educational technology, early learning, and education services, creating a more comprehensive offering for students, teachers and schools. The acquisition would provide added digital infrastructure and expertise to support the continued development of next-generation products for HMH s pre-K-12 and consumer businesses.

Revolving Credit Facility Amendment and New Term Loan

On April 23, 2015, we entered into Amendment No. 3 to our revolving credit facility. Amendment No. 3 permits us to increase the aggregate amount of indebtedness we may incur under our term loan agreement to $500.0 million, plus the aggregate amount of any incremental facilities provided for therein. We expect to seek an additional amendment that will permit us to increase the aggregate amount of indebtedness we may incur under our term loan agreement to $800.0 million, plus the aggregate amount of any incremental facilities provided for therein. No funds have been drawn on the revolving credit facility as of May 7, 2015.

In connection with the proposed EdTech acquisition, we expect to replace our existing $178.9 million term loan with a new $800.0 million senior secured facility, having a six-year maturity (the New Term Loan). We expect to use the net proceeds from the New Term Loan to refinance our existing term loan, to finance a portion of the acquisition of the EdTech business, to pay fees and expenses an