

RENAL CARE GROUP INC

Form 10-Q

November 12, 2002

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**SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

(Mark One)
x

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

For the Quarterly Period Ended September 30, 2002

OR

o

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

For the transition period from _____ to _____

Commission File No. 0-27640

RENAL CARE GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

62-1622383
(I.R.S. Employer Identification No.)

2525 West End Avenue, Suite 600, Nashville, Tennessee 37203

(Address of principal executive offices) (Zip code)

Registrant's telephone number, including area code: (615) 345-5500

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 o

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

Class	Outstanding at November 8, 2002
Common Stock, \$0.01 par value	48,394,770

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RENAL CARE GROUP, INC.
Condensed Consolidated Balance Sheets
(in thousands, except per share data)

	<u>December 31,</u> <u>2001</u>	<u>September 30,</u> <u>2002</u>
		(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 27,423	\$ 39,802
Accounts receivable, net	127,056	142,474
Inventories	16,292	15,252
Prepaid expenses and other current assets	18,584	15,045
Income taxes receivable	7,058	
Deferred income taxes	16,894	16,894
	<hr/>	<hr/>
Total current assets	213,307	229,467
Property, plant and equipment, net	175,925	198,038
Goodwill	243,530	262,798
Intangible assets, net	10,365	11,691
Other assets	7,922	5,423
	<hr/>	<hr/>
Total assets	\$ 651,049	\$ 707,417
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 28,198	\$ 20,830
Income taxes payable		7,141
Current portion of long-term debt	726	123
Other current liabilities	80,336	97,622
	<hr/>	<hr/>
Total current liabilities	109,260	125,716
Long-term debt, net of current portion	3,776	2,805
Deferred income taxes	12,728	12,728
Minority interest	15,034	27,850
	<hr/>	<hr/>
Total liabilities	140,798	169,099
	<hr/>	<hr/>
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.01 par value, 10,000 shares authorized, none issued		
Common stock, \$0.01 par value, 90,000 shares authorized, 49,597 and 50,632 shares issued at December 31, 2001 and September 30, 2002, respectively	496	507
Treasury stock, 100 and 2,098 shares of common stock at December 31, 2001 and September 30, 2002, respectively	(3,059)	(65,755)
Additional paid-in capital	277,300	300,487
Retained earnings	235,514	303,079

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Total stockholders' equity	<u>510,251</u>	<u>538,318</u>
Total liabilities and stockholders' equity	<u>\$651,049</u>	<u>\$707,417</u>

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
Condensed Consolidated Income Statements
(in thousands, except per share data)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2002	2001	2002
Net revenue	\$ 193,149	\$ 231,542	\$ 551,382	\$ 660,389
Operating costs and expenses:				
Patient care costs	125,020	151,722	357,166	432,184
General and administrative expenses	16,430	19,686	47,222	56,033
Provision for doubtful accounts	5,215	6,008	14,885	17,228
Depreciation and amortization	9,997	10,402	28,121	29,697
Total operating costs and expenses	156,662	187,818	447,394	535,142
Income from operations	36,487	43,724	103,988	125,247
Interest expense, net	198	569	2,470	880
Income before minority interest and income taxes	36,289	43,155	101,518	124,367
Minority interest	4,104	5,364	10,956	15,381
Income before income taxes	32,185	37,791	90,562	108,986
Provision for income taxes	12,288	14,361	34,591	41,421
Net income	\$ 19,897	\$ 23,430	\$ 55,971	67,565
Net income per share:				
Basic	\$ 0.41	\$ 0.48	\$ 1.17	\$ 1.37
Diluted	\$ 0.39	\$ 0.46	\$ 1.12	\$ 1.32
Weighted average shares outstanding:				
Basic	48,518	48,672	47,791	49,190
Diluted	50,904	50,518	50,187	51,036

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
Condensed Consolidated Statements Of Cash Flows
(in thousands)
(unaudited)

	Nine Months Ended September 30,	
	2001	2002
OPERATING ACTIVITIES		
Net income	\$ 55,971	\$ 67,565
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	28,121	29,697
Distributions to minority shareholders	(9,552)	(5,461)
Income applicable to minority interest	10,956	15,381
Changes in operating assets and liabilities net of effects from acquisitions	13,685	20,183
	99,181	127,365
INVESTING ACTIVITIES		
Purchases of property and equipment	(44,083)	(49,413)
Cash paid for acquisitions, net of cash acquired	(21,403)	(19,904)
Change in other assets	3,355	(843)
	(62,131)	(70,160)
FINANCING ACTIVITIES		
Net payments of debt	(51,285)	(1,574)
Net proceeds from issuance of common stock	23,992	16,548
Investment by joint venture partner		2,896
Repurchase of treasury shares		(62,696)
	(27,293)	(44,826)
Increase in cash and cash equivalents	9,757	12,379
Cash and cash equivalents, at beginning of period	29,902	27,423
	\$ 39,659	\$ 39,802
	\$ 39,659	\$ 39,802

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
FOR THE NINE MONTHS ENDED
SEPTEMBER 30, 2002
(Dollar amounts in thousands, except per share data)
(unaudited)

1. Basis of Presentation

Overview

Renal Care Group, Inc. provides dialysis services to patients with chronic kidney failure, also known as end-stage renal disease (ESRD). As of September 30, 2002, the Company provided dialysis and ancillary services to nearly 20,000 patients through 260 outpatient dialysis centers in 26 states, in addition to providing acute dialysis services in more than 120 hospitals.

Renal Care Group's net revenue has been derived primarily from the following sources:

outpatient hemodialysis services;

ancillary services associated with dialysis, primarily the administration of erythropoietin (also known as Epogen® or EPO) and other drugs;

home dialysis services;

inpatient hemodialysis services provided to acute care hospitals and skilled nursing facilities;

laboratory services; and

management contracts with hospital-based and medical university dialysis programs.

Patients with end-stage renal disease typically receive three dialysis treatments each week, with reimbursement for services provided primarily by the Medicare ESRD program based on rates established by Congress or the Centers for Medicare & Medicaid Services (CMS). For the nine months ended September 30, 2002, approximately 58% of the Company's net revenue was derived from reimbursement under the Medicare and Medicaid programs. Medicare reimbursement is subject to rate and other legislative changes by Congress and periodic changes in regulations, including changes that may reduce payments under the ESRD program. Effective January 1, 2001, Congress increased the Medicare composite rate by 1.2%. An additional increase of 1.2% took effect April 1, 2001. The April 1, 2001 increase included an adjustment factor that made that 1.2% increase effective for all of 2001. Accordingly, the net result of the 1.2% increases on January 1, 2001 and April 1, 2001, plus the April adjustment factor, was an effective increase of 2.4% for calendar year 2001. Neither Congress nor CMS approved an increase in the composite rate for 2002. Although a Medicare spending bill has not been approved as of the date of this quarterly report, neither Congress nor CMS has approved an increase in the Medicare composite rate for 2003, and management believes that the likelihood that Congress or CMS will approve an increase in the dialysis composite rate for 2003 is no better than 50% as of the date of this quarterly report.

The Medicare composite rate applies to a designated group of outpatient dialysis services, including the dialysis treatment, supplies used for the treatment, certain laboratory tests and medications, and most of the home

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dialysis services provided by Renal Care Group. Certain other services, laboratory tests, and drugs are eligible for separate reimbursement under Medicare and are not part of the composite rate, including specific drugs such as EPO and some physician-ordered tests provided to dialysis patients.

For patients with private health insurance, dialysis is typically reimbursed at rates significantly higher than Medicare during the first 30 months of treatment. After that period Medicare becomes the primary payor. Reimbursement for dialysis services provided pursuant to a hospital contract is negotiated with the individual hospital and generally is higher than the Medicare composite rate on a per treatment equivalent basis. Because dialysis is a life-sustaining therapy to treat a chronic disease, utilization is predictable and is not subject to seasonal fluctuations.

Renal Care Group derives a significant portion of its net revenue and net income from the administration of EPO. EPO is manufactured by a single company, Amgen Inc. In April 2002, Amgen implemented its third EPO price increase of 3.9% in as many years. This increase will not affect Renal Care Group's results of operations in 2002 because Renal Care Group's contract with Amgen included price protection for all of 2002. The Company is currently engaged in negotiations with Amgen concerning its contract for 2003. Renal Care Group and Amgen have agreed in principle that the Company's current pricing formula will remain in effect for 2003. As a result, the Company believes, although it can give no assurances, that it will be able to mitigate a substantial portion of the 2002 price increase in 2003. This agreement in principle is conditioned on negotiating and finalizing a written amendment to the contract between the Company and Amgen.

Interim Financial Statements

In the opinion of management, the information contained in this quarterly report on Form 10-Q reflects all adjustments necessary to make the results of operations for the interim periods a fair representation of such operations. All such adjustments are of a normal recurring nature. Operating results for interim periods are not necessarily indicative of results that may be expected for the year as a whole. The Company suggests that persons read these financial statements in conjunction with the consolidated financial statements and the related notes thereto included in the Company's Form 10-K, as filed with the SEC on March 29, 2002.

2. Reclassifications

Certain prior period balances have been reclassified to conform to the current period presentation. Such reclassifications had no effect on the results of operations as previously reported.

3. Goodwill and Intangible Assets

On January 1, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*, which addresses the financial accounting and reporting standards for the acquisition of intangible assets and for goodwill and other intangible assets subsequent to the acquisition. This accounting standard requires that goodwill be disclosed separately from other intangible assets in the balance sheet and that goodwill no longer be amortized; instead, goodwill will be tested for impairment on a periodic basis. The provisions of this accounting standard required the Company to complete a transitional impairment test within six months of the Company's adoption of this standard, with any identified impairments treated as a cumulative effect of a change in accounting principle. The Company has completed its transitional impairment test, and it has identified no impairments.

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In accordance with SFAS No. 142, the Company discontinued the amortization of goodwill effective January 1, 2002. A reconciliation of previously reported net income and earnings per share to the pro forma amounts adjusted for the exclusion of goodwill amortization net of the related income tax effect follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2001	2002	2001	2002
Reported net income	\$ 19,897	\$ 23,430	\$ 55,971	\$ 67,565
Add: goodwill amortization, net of tax	1,031		2,925	
Pro forma adjusted net income	\$ 20,928	\$ 23,430	\$ 58,896	\$ 67,565
Reported basic earnings per share	\$ 0.41	\$ 0.48	\$ 1.17	\$ 1.37
Add: goodwill amortization, net of tax	0.02		0.06	
Pro forma adjusted basic earnings per share	\$ 0.43	\$ 0.48	\$ 1.23	\$ 1.37
Reported diluted earnings per share	\$ 0.39	\$ 0.46	\$ 1.12	\$ 1.32
Add: goodwill amortization, net of tax	0.02		0.05	
Pro forma adjusted diluted earnings per share	\$ 0.41	\$ 0.46	\$ 1.17	\$ 1.32

Changes in the carrying amount of goodwill for the nine months ended September 30, 2002, are as follows:

Balance as of December 31, 2001	\$ 243,530
Goodwill acquired during the period	19,268
Balance as of September 30, 2002	\$ 262,798

The Company's separately identifiable intangible assets, which consist of noncompete agreements and acute dialysis services agreements, are as follows:

	December 31, 2001	September 30, 2002
Carrying amount	\$ 16,090	\$ 18,757
Accumulated amortization	(5,725)	(7,066)
Net	\$ 10,365	\$ 11,691

Separately identifiable intangible assets are being amortized over their useful lives, ranging from four to ten years. Amortization expense for the nine months ended September 30, 2002 was approximately \$1,341. Estimated amortization expense for each of the five succeeding fiscal years is as follows:

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Year ending December 31,	Amount
2002	\$2,010
2003	2,139
2004	2,139
2005	2,122
2006	2,067

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4. Earnings Per Share (in thousands, except per share data)

The following table sets forth the computation of basic and diluted income per share: