WATSON PHARMACEUTICALS INC
Form 10-Q
May 01, 2009

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

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2009
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 number 001-13305

WATSON PHARMACEUTICALS, INC.
(Exact name of registrant as specified in its charter)

Nevada	**95-3872914**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

311 Bonnie Circle
Corona, CA 92880-2882
(Address of principal executive offices, including zip code)
(951) 493-5300
(Registrant s telephone number, including area code)

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 þ No o

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes o No o

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. (Check one):

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares outstanding of the Registrant s only class of common stock as of April 27, 2009 was approximately 105,412,000.

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WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited; in millions)

	March 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 559.0	$ 507.6
Marketable securities	11.8	13.2
Accounts receivable, net	353.6	305.0
Inventories, net	476.2	473.1
Prepaid expenses and other current assets	49.3	48.5
Deferred tax assets	113.9	111.0
Total current assets	1,563.8	1,458.4
Property and equipment, net	649.0	658.5
Investments and other assets	81.2	80.6
Deferred tax assets	42.8	52.3
Product rights and other intangibles, net	546.0	560.0
Goodwill	868.1	868.1
Total assets	$ 3,750.9	$ 3,677.9
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 382.8	$ 381.3
Income taxes payable	22.2	15.5
Short-term debt and current portion of long-term debt	626.4	53.2
Deferred revenue	22.0	16.1
Deferred tax liabilities	89.2	15.9
Total current liabilities	1,142.6	482.0
Long-term debt	250.0	824.7
Deferred revenue	31.1	30.1
Other long-term liabilities	5.0	4.9
Other taxes payable	58.1	53.3
Deferred tax liabilities	100.5	174.3
Total liabilities	1,587.3	1,569.3
Commitments and contingencies		
Stockholders equity:		
Preferred stock		
Common stock	0.4	0.4
Additional paid-in capital	1,004.1	995.9
Retained earnings	1,467.2	1,418.1
Accumulated other comprehensive loss	(3.3)	(3.2)

Treasury stock, at cost		(304.8)		(302.6)
Total stockholders equity		2,163.6		2,108.6
Total liabilities and stockholders equity	$	3,750.9	$	3,677.9

See accompanying Notes to Condensed Consolidated Financial Statements.

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WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited; in millions, except per share amounts)

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
Net revenues	$ 667.4	$ 626.9
Cost of sales (excludes amortization, presented below)	388.7	380.1
Gross profit	278.7	246.8
Operating expenses:		
Research and development	42.3	38.0
Selling and marketing	65.7	56.1
General and administrative	68.9	50.5
Amortization	21.8	20.2
Gain on asset sales	(1.5)	
Total operating expenses	197.2	164.8
Operating income	81.5	82.0
Non-operating (expense) income:		
Loss on early extinguishment of debt		(1.1)
Interest income	2.0	2.3
Interest expense	(4.7)	(6.8)
Other income	1.2	5.4
Total other expense, net	(1.5)	(0.2)
Income before income taxes	80.0	81.8
Provision for income taxes	30.9	31.2
Net income	$ 49.1	$ 50.6
Earnings per share:		
Basic	$ 0.48	$ 0.49
Diluted	$ 0.43	$ 0.45
Weighted average shares outstanding:		
Basic	103.1	102.6

Diluted	118.2	117.4

See accompanying Notes to Condensed Consolidated Financial Statements.

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WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited; in millions)

	Three Months Ended March 31, 2009	Three Months Ended March 31, 2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 49.1	$ 50.6
Reconciliation to net cash provided by operating activities:		
Depreciation	23.2	21.8
Amortization	21.8	20.2
Deferred income tax provision	5.7	6.4
Provision for inventory reserve	12.3	9.1
Restricted stock and stock option compensation	4.5	4.3
Earnings on equity method investments	(2.2)	(4.0)
Loss (gain) on securities	1.1	(1.4)
Loss on early extinguishment of debt		1.1
Gain on asset sales	(1.5)	
Other	(0.1)	1.6
Changes in assets and liabilities:		
Accounts receivable, net	(48.6)	(6.2)
Inventories	(15.3)	(39.8)
Prepaid expenses and other current assets	(0.8)	12.8
Accounts payable and accrued expenses	1.5	(26.1)
Deferred revenue	6.8	(8.6)
Income taxes payable	10.8	24.3
Other assets	1.2	0.5
Total adjustments	20.4	16.0
Net cash provided by operating activities	69.5	66.6
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property and equipment	(15.3)	(18.3)
Acquisition of product rights	(7.8)	(0.2)
Proceeds from sale of fixed assets	3.0	
Proceeds from sale of marketable securities	2.2	1.6
Additions to marketable securities		(1.3)
Net cash used in investing activities	(17.9)	(18.2)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments on debt and other long-term liabilities	(1.6)	(88.1)
Proceeds from issuance of short-term debt and other long-term liabilities		9.1

Repurchase of common stock	(2.2)	(0.1)
Proceeds from stock plans	3.6	0.1
Net cash used in financing activities	(0.2)	(79.0)
Net increase (decrease) in cash and cash equivalents	51.4	(30.6)
Cash and cash equivalents at beginning of period	507.6	204.6
Cash and cash equivalents at end of period	$ 559.0	$ 174.0

See accompanying Notes to Condensed Consolidated Financial Statements.

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WATSON PHARMACEUTICALS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 GENERAL

Watson Pharmaceuticals, Inc. (Watson or the Company) is primarily engaged in the development, manufacturing, marketing, sale and distribution of brand and off-patent (generic) pharmaceutical products. Watson was incorporated in 1985 and began operations as a manufacturer and marketer of off-patent pharmaceuticals. Through internal product development and synergistic acquisitions of products and businesses, the Company has grown into a diversified specialty pharmaceutical company. Watson operates manufacturing, distribution, research and development (R&D) and administrative facilities predominantly in the United States of America (U.S.) and India with our key commercial market being the U.S.

The accompanying condensed consolidated financial statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2008. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted from the accompanying condensed consolidated financial statements. The year end condensed consolidated balance sheet was derived from the audited financial statements. The accompanying interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, necessary to present fairly Watson s consolidated financial position, results of operations and cash flows for the periods presented. Unless otherwise noted, all such adjustments are of a normal, recurring nature. The Company s results of operations and cash flows for the interim periods are not necessarily indicative of the results of operations and cash flows that it may achieve in future periods.

Comprehensive Income

Comprehensive income includes all changes in equity during a period except those that resulted from investments by or distributions to the Company s stockholders. Other comprehensive income refers to revenues, expenses, gains and losses that, under generally accepted accounting principles, are included in comprehensive income, but excluded from net income. The components of comprehensive income including attributable income taxes consisted of the following (in millions):

	Three Months Ended March 31,	
	2009	**2008**
Net income	$ 49.1	$ 50.6
Other comprehensive loss:		
Translation (losses) gains	(1.3)	0.3
Unrealized loss on securities, net of tax	(0.2)	
Reclassification for losses included in net income, net of tax	1.4	
Unrealized loss on cash flow hedge, net of tax		(1.3)
Total other comprehensive loss	(0.1)	(1.0)
Total comprehensive income	$ 49.0	$ 49.6

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Preferred and Common Stock

As of March 31, 2009 and December 31, 2008 there were 2,500,000 shares of no par value per share preferred stock authorized, with none issued. As of March 31, 2009 and December 31, 2008, there were 500,000,000 shares of $0.0033 par value per share common stock authorized, with 114,945,000 and 114,095,000 shares issued and 105,380,000 and 104,608,000 outstanding, respectively. Of the issued shares, 9,565,000 and 9,487,000 shares were held as treasury shares as of March 31, 2009 and December 31, 2008, respectively.

Provisions for Sales Returns and Allowances

As customary in the pharmaceutical industry, the Company s gross product sales are subject to a variety of deductions in arriving at reported net product sales. When the Company recognizes revenue from the sale of its products, an estimate of sales returns and allowances (SRA) is recorded which reduces product sales. Accounts receivable and/or accrued liabilities are also reduced and/or increased by the SRA amount. These adjustments include estimates for chargebacks, rebates, cash discounts and returns and other allowances. These provisions are estimated based on historical payment experience, historical relationship to revenues, estimated customer inventory levels and current contract sales terms with direct and indirect customers. The estimation process used to determine our SRA provision has been applied on a consistent basis and no material adjustments have been necessary to increase or decrease our reserves for SRA as a result of a significant change in underlying estimates. The Company uses a variety of methods to assess the adequacy of our SRA reserves to ensure that our condensed consolidated financial statements are fairly stated. This includes periodic reviews of customer inventory data, customer contract programs and product pricing trends to analyze and validate the SRA reserves.

The provision for chargebacks is our most significant sales allowance. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price paid to the Company by our wholesale customer for a particular product and the negotiated contract price that the wholesaler s customer pays for that product. The Company s chargeback provision and related reserve vary with changes in product mix, changes in customer pricing and changes to estimated wholesaler inventories. The provision for chargebacks also takes into account an estimate of the expected wholesaler sell-through levels to indirect customers at contract prices. The Company validates the chargeback accrual quarterly through a review of the inventory reports obtained from our largest wholesale customers. This customer inventory information is used to verify the estimated liability for future chargeback claims based on historical chargeback and contract rates. These large wholesalers represent 85% - 90% of the Company s chargeback payments. The Company continually monitors current pricing trends and wholesaler inventory levels to ensure the liability for future chargebacks is fairly stated.

Net revenues and accounts receivable balances in the Company s condensed consolidated financial statements are presented net of SRA estimates. Certain SRA balances are included in accounts payable and accrued liabilities. Accounts receivable are presented net of SRA balances of $271.4 million and $285.7 million at March 31, 2009 and December 31, 2008, respectively. Accounts payable and accrued liabilities include $44.4 million and $42.4 million at March 31, 2009 and December 31, 2008, respectively, for certain rebates and other amounts due to indirect customers.

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The following table summarizes the activity in the Company s major categories of SRA (in millions):

	Chargebacks	Rebates	Returns and Other Allowances	Cash Discounts	Total
Balance at December 31, 2007	$ 164.4	$ 154.3	$ 56.1	$ 12.9	$ 387.7
Provision related to sales in three months ended March 31, 2008	313.9	78.5	45.1	16.6	454.1
Credits and payments	(323.2)	(86.0)	(38.4)	(14.3)	(461.9)
Balance at March 31, 2008	155.1	146.8	62.8	15.2	379.9
Provision related to sales in three quarters ended December 31, 2008	910.1	230.6	134.7	50.6	1,326.0
Credits and payments	(944.6)	(251.6)	(128.0)	(53.5)	(1,377.7)
Balance at December 31, 2008	120.6	125.8	69.5	12.3	328.2
Provision related to sales in three months ended March 31, 2009	275.2	88.3	47.3	17.3	428.1
Credits and payments	(289.2)	(96.2)	(39.8)	(15.3)	(440.5)
Balance at March 31, 2009	$ 106.6	$ 117.9	$ 77.0	$ 14.3	$ 315.8

Earnings Per Share (EPS)

Basic EPS is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted EPS is based on the treasury stock method and includes the effect from potential issuance of common stock, such as shares issuable upon conversion of the $575 million convertible contingent senior debentures (CODES), and the dilutive effect of share-based compensation arrangements outstanding during the period. Common share equivalents have been excluded where their inclusion would be anti-dilutive. In accordance with Emerging Issues Task Force (EITF) Issue No. 04-8, The Effect of Contingently Convertible Debt on Diluted Earnings per Share, the Company is required to add approximately 14.4 million shares associated with the conversion of the CODES to the number of shares outstanding for the calculation of diluted EPS for all periods in which the securities were outstanding. A reconciliation of the numerators and denominators of basic and diluted EPS consisted of the following (in millions, except per share amounts):

	Three months ended March 31, 2009	Three months ended March 31, 2008
EPS basic		
Net income	$ 49.1	$ 50.6
Basic weighted average common shares outstanding	103.1	102.6
EPS basic	$ 0.48	$ 0.49

EPS diluted		
Net income	$ 49.1	$ 50.6
Add: Interest expense on CODES, net of tax	1.9	2.0
Net income, adjusted	$ 51.0	$ 52.6
Basic weighted average common shares outstanding	103.1	102.6
Effect of dilutive securities:		
Conversion of CODES	14.4	14.4
Dilutive stock options	0.7	0.4
Diluted weighted average common shares outstanding	118.2	117.4
EPS diluted	$ 0.43	$ 0.45

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Stock awards to purchase 6.0 million and 9.0 million common shares for the three month periods ended March 31, 2009 and 2008, respectively, were outstanding but were not included in the computation of diluted earnings per share because the options were antidilutive.

Share-Based Compensation

The Company accounts for share-based compensation under Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123R) which requires the measurement and recognition of compensation expense for all share-based compensation awards made to employees and directors based on estimated fair values.

As of March 31, 2009, the Company had $3.0 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option grants, which will be recognized over the remaining weighted average period of 1.4 years. As of March 31, 2009, the Company had $28.8 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock grants, which will be recognized over the remaining weighted average period of 2.2 years. During the three months ended March 31, 2009, the Company issued approximately 782,000 restricted stock grants with an aggregate intrinsic value of $21.9 million. No stock option grants were issued during the three months ended March 31, 2009.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 157, Fair-Value Measurements, (SFAS 157) which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair-value measurements. The Company adopted SFAS 157 effective January 1, 2008 for all financial assets and liabilities and any other assets and liabilities that are recognized or disclosed at fair value on a recurring basis (refer to NOTE 9 FAIR VALUE MEASUREMENT in the accompanying Notes to Condensed Consolidated Financial Statements in this Quarterly Report). For nonfinancial assets and liabilities measured at fair value on a non-recurring basis, SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2008. The adoption of SFAS 157 for nonfinancial assets and liabilities measured at fair value on a non-recurring basis on January 1, 2009 did not have a material impact on the Company s condensed consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations, (SFAS 141R) which replaces SFAS No. 141, Business Combinations . SFAS 141R establishes principles and requirements for recognizing and measuring identifiable assets and goodwill acquired, liabilities assumed and any noncontrolling interest in a business combination at their fair value at acquisition date. SFAS 141R alters the treatment of acquisition-related costs, business combinations achieved in stages (referred to as a step acquisition), the treatment of gains from a bargain purchase, the recognition of contingencies in business combinations, the treatment of in-process research and development in a business combination as well as the treatment of recognizable deferred tax benefits. SFAS 141R is effective for business combinations closed in fiscal years beginning after December 15, 2008. As SFAS 141R is applicable to business acquisitions completed after January 1, 2009 and the Company did not have any business acquisitions during the quarter ended March 31, 2009, the adoption of SFAS 141R did not have a material impact on the Company s condensed consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin No. 51, (SFAS 160). SFAS 160 establishes accounting and reporting standards for the noncontrolling interest (minority interest) in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The Company currently has no minority interests and accordingly the adoption of SFAS 160 did not have a material impact on its condensed consolidated financial statements.

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In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133, (SFAS 161). SFAS 161 requires enhanced disclosures about a company s derivative and hedging activities. SFAS 161 is effective for financial statements issued for fiscal years beginning after December 15, 2008. The adoption of SFAS 161 did not have a material impact on the Company s condensed consolidated financial statements.

In April 2008, the FASB issued FASB Staff Position (FSP) No. FAS 142-3, Determination of the Useful Life of Intangible Assets, (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, Goodwill and Other Intangible Assets and also requires expanded disclosure related to the determination of intangible asset useful lives. FSP 142-3 is effective for fiscal years beginning after December 15, 2008. The adoption of FSP 142-3 did not have a material impact on the Company s condensed consolidated financial statements.

NOTE 2 OTHER INCOME

Other income consisted of the following (in millions):

	Three Months Ended March 31,	
	2009	**2008**
Earnings on equity method investments	$ 2.2	$ 4.0
(Loss) gain on securities	(1.1)	1.4
Other income	0.1	
	$ 1.2	$ 5.4

NOTE 3 OPERATING SEGMENTS

Watson has three reportable operating segments: Generic, Brand and Distribution. The Generic segment includes pharmaceutical products that are therapeutically equivalent to proprietary products. The Brand segment includes the Company s lines of Specialty Products and Nephrology/Medical products. Watson has aggregated its brand product lines in a single segment because of similarities in regulatory environment, methods of distribution and types of customer. This segment includes patent-protected products and certain trademarked off-patent products that Watson sells and markets as brand pharmaceutical products. The Company sells its brand and generic products primarily to pharmaceutical wholesalers, drug distributors and chain drug stores in the U.S. The Distribution segment distributes generic pharmaceutical products and select brand pharmaceutical products manufactured by third parties to independent pharmacies, pharmacy chains, pharmacy buying groups and physicians offices in the U.S. Sales are principally generated through an in-house telemarketing staff and through internally developed ordering systems. The Distribution segment operating results exclude sales of Watson products, which are included in their respective Generic and Brand segment results.

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Segment net revenues, segment gross profit and segment contribution information for the Company s Generic, Brand and Distribution segments consisted of the following (in millions):

	Three Months Ended March 31, 2009				Three Months Ended March 31, 2008			
	Generic	Brand	Distribution	Total	Generic	Brand	Distribution	Total
Product sales	$ 395.2	$ 98.2	$ 153.7	$ 647.1	$ 342.4	$ 99.0	$ 144.9	$ 586.3
Other	6.5	13.8		20.3	24.3	16.3		40.6
Net revenues	401.7	112.0	153.7	667.4	366.7	115.3	144.9	