

RENAL CARE GROUP INC

Form 10-Q

November 12, 2003

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2003

OR

**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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes No

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 10, 2003
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Common Stock, \$.01 par value

48,731,871

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

	December 31, 2002	September 30, 2003
		(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 38,359	\$ 121,128
Accounts receivable, net	152,440	157,218
Inventories	23,336	14,670
Prepaid expenses and other current assets	19,486	22,350
Deferred income taxes	12,240	4,290
	<u>245,861</u>	<u>319,656</u>
Total current assets	245,861	319,656
Property, plant and equipment, net	202,972	214,858
Intangible assets, net	12,110	13,567
Other assets	3,514	11,543
Goodwill	275,666	279,542
	<u>740,123</u>	<u>839,166</u>
Total assets	\$ 740,123	\$ 839,166
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 101,213	\$ 99,187
Due to third-party payors	32,611	43,939
Income taxes payable	1,423	6,176
Current portion of long-term debt	133	413
	<u>135,380</u>	<u>149,715</u>
Total current liabilities	135,380	149,715
Long-term debt, net of current portion	10,161	2,673
Other long-term liabilities		4,677
Deferred income taxes	19,288	19,288
Minority interest	31,406	34,036
	<u>196,235</u>	<u>210,389</u>
Total liabilities	196,235	210,389
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, 51,176 and 52,882 shares issued at December 31, 2002 and September 30, 2003, respectively	512	529
Treasury stock, 2,983 and 3,998 shares of common stock at December 31, 2002 and September 30, 2003, respectively	(93,953)	(129,195)
Additional paid-in capital	309,355	355,359
Retained earnings	327,974	402,084

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Total stockholders' equity	<u>543,888</u>	<u>628,777</u>
Total liabilities and stockholders' equity	<u>\$740,123</u>	<u>\$839,166</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,	
	2002	2003	2002	2003
Net revenue	\$ 231,542	\$ 253,835	\$ 660,389	\$ 743,039
Operating costs and expenses:				
Patient care costs	151,722	164,962	432,184	482,437
General and administrative expenses	19,686	21,225	56,033	68,700
Provision for doubtful accounts	6,008	6,556	17,228	19,436
Depreciation and amortization	10,402	11,365	29,697	33,242
Total operating costs and expenses	187,818	204,108	535,142	603,815
Income from operations	43,724	49,727	125,247	139,224
Interest expense, net	569	76	880	526
Income before minority interest and income taxes	43,155	49,651	124,367	138,698
Minority interest	5,364	6,837	15,381	19,174
Income before income taxes	37,791	42,814	108,986	119,524
Provision for income taxes	14,361	16,269	41,421	45,414
Net income	\$ 23,430	\$ 26,545	\$ 67,565	\$ 74,110
Net income per share:				
Basic	\$ 0.48	\$ 0.54	\$ 1.37	\$ 1.53
Diluted	\$ 0.46	\$ 0.53	\$ 1.32	\$ 1.48
Weighted average shares outstanding:				
Basic	48,672	49,022	49,190	48,580
Diluted	50,518	50,417	51,036	49,926

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,	
	2002	2003
OPERATING ACTIVITIES		
Net income	\$ 67,565	\$ 74,110
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	29,697	33,242
Loss on disposal of property and equipment		443
Income applicable to minority interest	15,381	19,174
Distributions to minority shareholders	(5,461)	(16,819)
Deferred income taxes		7,950
Changes in operating assets and liabilities, net of effects from acquisitions	20,183	30,163
Net cash provided by operating activities	127,365	148,263
INVESTING ACTIVITIES		
Purchases of property and equipment	(49,413)	(44,043)
Cash paid for acquisitions	(19,904)	(14,154)
Change in other assets	(843)	(1,968)
Net cash used in investing activities	(70,160)	(60,165)
FINANCING ACTIVITIES		
Net payments of debt	(1,574)	(7,208)
Repurchase of treasury shares	(62,696)	(35,242)
Net proceeds from issuance of common stock	16,548	37,121
Investment by joint venture partner	2,896	
Net cash used in financing activities	(44,826)	(5,329)
Increase in cash and cash equivalents	12,379	82,769
Cash and cash equivalents at beginning of period	27,423	38,359
Cash and cash equivalents at end of period	\$ 39,802	\$ 121,128

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, 2003**

(dollars 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, 2003, the Company provided dialysis and ancillary services to more than 21,300 patients through 281 owned outpatient dialysis centers in 27 states, in addition to providing acute dialysis services at approximately 130 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.

Most patients with end-stage renal disease receive three dialysis treatments each week in an outpatient setting. Reimbursement for these services is provided primarily by the Medicare ESRD program based on rates established by the Centers for Medicare and Medicaid Services (CMS). For the nine months ended September 30, 2003, approximately 55% 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. Neither Congress nor CMS approved an increase in the composite rate for either 2002 or 2003.

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 dialysis services provided by Renal Care Group. The Company receives separate reimbursement outside the composite rate for some other services, drugs (including specific drugs such as EPO) and some physician-ordered tests (including some laboratory tests) provided to dialysis patients.

If a patient has private health insurance, that patient's treatment is typically reimbursed at rates significantly higher than those paid by Medicare during the first 30 months of care. After that period Medicare becomes the primary payor. Reimbursement for dialysis services provided pursuant to a hospital contract is

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negotiated with the individual hospital and is usually higher than Medicare rates. 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. Because the Company was already under contract with Amgen through 2002, this price increase did not affect its results of operations during 2002. Key components of the 2002 pricing formula were maintained in the Company's 2003 contract with Amgen. Therefore, while the 2002 price increase has had and will continue to have an adverse affect on the Company's 2003 results of operations, the Company believes it has been able to mitigate approximately 80% of the increase.

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 18, 2003.

2. Net Income per Share

The following table sets forth the computation of basic and diluted net income per share (shares in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2003	2002	2003
Numerator:				
Numerator for basic and diluted net income per share net income	\$ 23,430	\$ 26,545	\$ 67,565	\$ 74,110
Denominator:				
Denominator for basic net income per share weighted-average shares	48,672	49,022	49,190	48,580
Effect of dilutive securities:				
Stock options	1,749	1,395	1,749	1,346
Warrants	97		97	
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Denominator for diluted net income per share adjusted weighted-average shares and assumed conversions	50,518	50,417	51,036	49,926
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net income per share:				
Basic	\$ 0.48	\$ 0.54	\$ 1.37	\$ 1.53
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Diluted	\$ 0.46	\$ 0.53	\$ 1.32	\$ 1.48
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

3. Stock-Based Compensation

The Company accounts for stock-based compensation to employees and directors using the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. In accordance with that opinion, the Company recognizes no compensation expense when it grants fixed options to employees and directors, because the exercise price of

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the stock options equals or exceeds the market price of the underlying stock on the dates of grant. Option grants to medical directors and non-vested stock grants are expensed over their vesting periods.

The following table presents the pro forma effect on net income and net income per share as if the Company had applied the fair value based method and recognition provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, (SFAS No. 123) to stock-based compensation to employees and directors:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2003	2002	2003
Net income, as reported	\$23,430	\$26,545	\$67,565	\$74,110
Add: stock-based compensation expense, net of related tax effects, included in the determination of net income as reported	95	40	285	384
Less: stock-based compensation expense, net of related tax effects, determined by the fair value-based method	(2,098)	(2,223)	(5,822)	(6,986)
Pro forma net income	\$21,427	\$24,362	\$62,028	\$67,508
Net income per share:				
Basic, as reported	\$ 0.48	\$ 0.54	\$ 1.37	\$ 1.53
Basic, pro forma	\$ 0.44	\$ 0.50	\$ 1.26	\$ 1.39
Diluted, as reported	\$ 0.46	\$ 0.53	\$ 1.32	\$ 1.48
Diluted, pro forma	\$ 0.42	\$ 0.48	\$ 1.22	\$ 1.35

The effects of applying SFAS No. 123 for providing pro forma disclosures are not likely to be representative of the effects on reported net income for future periods.

4. Contingencies

On August 30, 2000, 19 patients were hospitalized and one patient died shortly after becoming ill while receiving treatment at one of the Company's dialysis centers in Youngstown, Ohio. One of the 19 hospitalized patients also died some time later. In March 2001, one of the affected patients sued the Company in Mahoning County, Ohio for injuries related to the August 30, 2000 incident. Additional suits have been filed, and as of September 30, 2003, a total of eight suits were pending. The suits allege negligence, medical malpractice and product liability. Additional defendants are named in each of the suits. Additional defendants in some of the suits include the water system vendors who installed and maintained the water system in the dialysis center. Renal Care Group has denied the allegations and has filed cross-claims against the water system vendors. Renal Care Group intends to pursue these cross-claims vigorously. Management believes that Renal Care Group's insurance should be adequate to cover these illnesses and does not anticipate a material adverse effect on the Company's consolidated financial position or results of operations.

The Company is involved in other litigation and regulatory investigations arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the Company believes these matters will be resolved without material adverse effect on the Company's consolidated financial position or results of operations.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. The Company believes that it is in compliance with all applicable laws and regulations governing the Medicare and Medicaid programs. The Company is not aware of any pending or threatened investigations involving allegations of potential noncompliance with applicable laws or regulations. While no

regulatory

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