RENAL CARE GROUP INC
Form 10-Q
May 10, 2004

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UNITED STATES
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 March 31, 2004

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	**62-1622383**
(State or other jurisdiction of incorporation or organization)	(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 by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). 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 May 6, 2004
Common Stock, $.01 par value	44,524,934

RENAL CARE GROUP, INC.

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Note: Items 1, 3, 4, and 5 of Part II are omitted because they are not applicable

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	December 31, 2003	March 31, 2004
		(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 50,295	$ 37,606
Accounts receivable, net	173,679	188,729
Inventories	26,345	18,314
Prepaid expenses and other current assets	28,050	14,537
Income tax receivable	1,910	2,413
Deferred income taxes	11,825	11,825
Total current assets	292,104	273,424
Property, plant and equipment, net	224,397	236,008
Intangible assets, net	14,046	18,154
Goodwill	286,578	331,093
Other assets	2,748	5,223
Total assets	$ 819,873	$ 863,902
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 123,206	$ 104,826
Due to third-party payors	46,049	50,244
Current portion of long-term debt	182	6,150
Total current liabilities	169,437	161,220
Long-term debt, net of current portion	2,652	143,171
Deferred income taxes	38,390	38,390
Other long-term liabilities	5,898	6,093
Minority interest	32,651	36,304

Total liabilities	249,028	385,178
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, 53,643 and 54,136 shares issued at December 31, 2003 and March 31, 2004, respectively	536	541
Treasury stock, 6,641 and 9,628 shares of common stock at December 31, 2003 and March 31, 2004, respectively	(234,404)	(370,040)
Additional paid-in capital	374,683	388,106
Retained earnings	430,030	460,117
Total stockholders equity	570,845	478,724
Total liabilities and stockholders equity	$ 819,873	$ 863,902

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 March 31,	
	2003	**2004**
Net revenue	$242,143	$278,028
Operating costs and expenses:		
Patient care costs	157,477	179,372
General and administrative expenses	26,288	22,676
Provision for doubtful accounts	6,412	7,110
Depreciation and amortization	10,298	12,163
Total operating costs and expenses	200,475	221,321
Income from operations	41,668	56,707
Interest expense, net	285	965
Income before minority interest and income taxes	41,383	55,742
Minority interest	6,308	7,214
Income before income taxes	35,075	48,528
Provision for income taxes	13,323	18,441
Net income	$ 21,752	$ 30,087
Net income per share:		
Basic	$ 0.45	$ 0.65
Diluted	$ 0.44	$ 0.63
Weighted average shares outstanding:		
Basic	48,182	45,940
Diluted	49,430	47,482

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)

	Three Months Ended March 31,	
	2003	**2004**
OPERATING ACTIVITIES		
Net income	$ 21,752	$ 30,087
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,298	12,163
Loss on disposal of property and equipment	136	154
Distributions to minority shareholders	(9,620)	(3,561)
Income applicable to minority interest	6,308	7,214
Changes in operating assets and liabilities, net of effects from acquisitions	3,306	(600)
Net cash provided by operating activities	32,180	45,457
INVESTING ACTIVITIES		
Purchases of property and equipment	(17,896)	(19,118)
Cash paid for acquisitions, net of cash acquired		(55,768)
Change in other assets	225	(3,173)
Net cash used in investing activities	(17,671)	(78,059)
FINANCING ACTIVITIES		
Net (payments) borrowings under line of credit and capital leases	(7,420)	25,921
Proceeds from issuance of long-term debt		120,000
Net proceeds from issuance of common stock	3,047	9,628
Repurchase of treasury shares	(4,380)	(135,636)
Net cash (used in) provided by financing activities	(8,753)	19,913
Increase (decrease) in cash and cash equivalents	5,756	(12,689)
Cash and cash equivalents at beginning of period	38,359	50,295
Cash and cash equivalents at end of period	$ 44,115	$ 37,606

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2004
(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 March 31, 2004, we provided dialysis and ancillary services to over 22,600 patients through more than 300 owned outpatient dialysis centers in 27 states, in addition to providing acute dialysis services at more than 140 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 EPOGEN® (erythropoietin alfa, which we refer to as EPO);
- 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 three months ended March 31, 2004 and 2003, approximately 55% and 56%, respectively, of our 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 2003 or 2004. Congress has approved an increase of 1.6% in the Medicare ESRD composite rate for 2005.

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 we provide. Renal Care Group receives separate reimbursement outside the composite rate for some other services, laboratory tests and drugs, including specific drugs such as EPO and some physician-ordered tests provided to dialysis patients. Congress and CMS have considered expanding the drugs and services that are included in the composite rate. Congress also mandated a change in the way we will be paid beginning in 2005 for some of the drugs (including EPO) billed for outside the composite rate. This change will result in lower reimbursement for these drugs and a higher composite rate.

If a patient is younger than 65 years old and has private health insurance, then that patient s treatment is typically reimbursed at rates significantly higher than 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

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is negotiated with the individual hospital and is usually higher than the Medicare composite rate. 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. The Company administers EPO to most of its patients to treat anemia, a medical complication frequently experienced by dialysis patients. Net revenue from the administration of EPO was 24% and 26% of the net revenue of the Company for the three months ended March 31, 2003 and 2004, respectively.

Interim Financial Statements

Management believes 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 of these 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. We suggest that you read these financial statements in conjunction with our consolidated financial statements and the related notes thereto included in our current report on Form 8-K, as filed with the SEC on April 19, 2004.

2. Business Acquisitions

2004 Acquisitions

During the first quarter of 2004, we completed certain acquisitions that were accounted for under the purchase method of accounting. The combined purchase price paid in these acquisitions was $55,768 and consisted primarily of cash. Each of the transactions involved the acquisition of the net assets of entities that provide care to ESRD patients through owned dialysis facilities. The acquired businesses either strengthened our existing market share within a specific geographic area or provided us with an entrance into a new market.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of acquisition for the acquisitions completed during the first quarter of 2004:

Accounts receivable, net	$ 774
Inventory and other current assets	831
Property, plant and equipment, net	7,367
Intangible assets	4,256
Goodwill	44,438
Total assets acquired	57,666
Total liabilities assumed	1,898
Net assets acquired	$55,768

We began recording the results of operations for each of these acquired businesses at the effective date of the respective transactions. Goodwill resulting from these transactions amounted to $44,438 and is expected to be deductible for tax purposes. Intangible assets typically represent the value assigned to certain contracts such as non-competition agreements and acute dialysis service agreements entered into in the transactions. We will amortize these amounts over the lives of the contracts, which generally range from five to twelve years.

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Pro Forma Data

The following summary, prepared on a pro forma basis, combines our results of operations with those of the businesses we acquired in 2003. These pro forma results reflect the acquisitions as if consummated as of the beginning of the period presented, giving effect to adjustments such as amortization of intangibles, interest expense and related income taxes. Each acquisition in the first quarter of 2004 was effective as of January 1, 2004; therefore, no pro forma data are presented for the 2004 period.

	Three months ended March 31, 2003
Pro forma net revenue	$252,220
Pro forma net income	$ 22,251
Pro forma net income per share:	
Basic	$ 0.46
Diluted	$ 0.45

The unaudited pro forma results of operations are not necessarily indicative of what actually would have occurred if the acquisitions had been completed as of the beginning of the periods presented.

3. 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 March 31,	
	2003	2004
Numerator:		
Numerator for basic and diluted net income per share net income	$21,752	$30,087
Denominator:		
Denominator for basic net income per share weighted-average shares	48,182	45,940
Effect of dilutive securities:		
Stock options	1,248	1,542

Denominator for diluted net income per share adjusted weighted-average shares and assumed conversions	49,430	47,482
Net income per share:		
Basic	$ 0.45	$ 0.65
Diluted	$ 0.44	$ 0.63

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4. Stockholders Equity

Stock-based Compensation

We account 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. Accordingly, we recognize no compensation expense when we grant fixed options to employees and directors, because the exercise price of 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 we 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 March 31,	
	2003	**2004**
Net income, as reported	$21,752	$30,087
Add: stock-based compensation expense, net of related tax effects, included in the determination of net income as reported	61	31
Less: stock-based compensation expense, net of related tax effects, determined by the fair value-based method	(2,487)	(2,387)
Pro forma net income	$19,326	$27,731
Net income per share:		
Basic, as reported	$ 0.45	$ 0.65
Basic, pro forma	$ 0.40	$ 0.60
Diluted, as reported	$ 0.44	$ 0.63
Diluted, pro forma	$ 0.39	$ 0.58

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

Stock Split

On April 27, 2004, we announced a three-for-two stock split in the form of a stock dividend to be distributed on or about May 24, 2004 to shareholders of record as of May 7, 2004. We will issue one share for every two shares held by shareholders as of the record date. The par value of our common stock will remain unchanged at $0.01.

5. Contingencies

On August 30, 2000, 19 patients were hospitalized and one patient died shortly after becoming ill while receiving treatment at one of our 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 March 31, 2004, a total of five 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. We have denied the allegations and have filed cross-claims against the water system vendors. We intend to pursue these cross-claims vigorously.

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Management believes that Renal Care Group s insurance should be adequate to cover these illnesses and does not anticipate a material adverse effect on our consolidated financial position or results of operations.

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

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. We believe that we are in compliance with all applicable laws and regulations governing the Medicare and Medicaid programs. We are not aware of any pending or threatened investigations involving allegations of potential noncompliance with applicable laws or regulations. While no regulatory inquiries have been made, compliance with such laws and regulations can be subject to future government review and interpretation, and non-compliance or alleged non-compliance could result in significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

We generally engage practicing board-certified or board-eligible nephrologists to serve as medical directors for our centers. Medical directors are responsible for the administration and monitoring of patient care policies, including patient education, administration of dialysis treatment, development programs and assessment of all patients in our dialysis centers. We pay medical director fees that are consistent with the fair market value of the required supervisory services. Our medical director agreements typically have terms of seven years with three-year renewal options.

6. Defined Benefit Plan

Effective January 29, 2003, we implemented a retirement benefit plan for our former Chairman, Chief Executive Officer and President who died March 20, 2003. The plan provides that we will make 120 monthly payments of $54 each to our former Chairman s beneficiary, beginning in April 2003. As a result, we recorded a $5,350 charge included in general and administrative expenses representing the pre-tax net present value of such payments during the first quarter of 2003. As of March 31, 2004, we have accrued liabilities totaling $4,906 related to this defined benefit plan.

7. Subsequent Event

On April 2, 2004, we completed our acquisition of National Nephrology Associates, Inc. (NNA). Prior to the acquisition, NNA provided dialysis services to approximately 5,600 patients and operated 87 outpatient dialysis facilities in 15 states, as well as providing acute dialysis services at approximately 55 hospitals.

The aggregate consideration paid for NNA was approximately $345,000, which included a cash payment of approximately $167,000 to NNA s equity holders and the assumption or payment by Renal Care Group of NNA s outstanding debt, including its $160,000 of 9% senior subordinated notes due 2011 (the Notes), and other indebtedness, including capital leases. As required by the indenture governing the Notes, we have made an offer to repurchase the notes at 101% of their face principal amount and have filed a registration statement with the SEC to register an exchange of registered notes for the Notes, which were not originally registered under the Securities Act of 1933.

We conduct substantially all of our business through subsidiaries. Our wholly-owned subsidiaries have guaranteed the Notes we assumed in the acquisition of NNA, as well as our senior credit facility. Presented below is condensed consolidating financial information as of March 31, 2004 and December 31, 2003 and for the three months ended March 31, 2004 and 2003, respectively. The information segregates Renal Care Group, Inc. (the parent company), the combined wholly-owned subsidiary guarantors, the combined non-guarantor subsidiaries and consolidating adjustments. All of the subsidiary guarantees are both full and unconditional, and joint and several.

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Condensed Consolidating Balance Sheets

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
As of March 31, 2004					
Cash and cash equivalents	$	$ 5,707	$ 33,714	$ (1,815)	$ 37,606
Accounts receivable, net		130,394	58,335		188,729
Other current assets	22,331	16,398	8,360		47,089
Total current assets	22,331	152,499	100,409	(1,815)	273,424
Property, plant and equipment, net	26,831	134,696	74,765	(284)	236,008
Goodwill	1,483	228,253	101,057	300	331,093
Other assets	9,273	81,233	5,962	(73,091)	23,377
Total assets	$ 59,918	$596,681	$282,193	$(74,890)	$863,902
Current liabilities (including intercompany assets and liabilities)	$(361,780)	$405,325	$130,395	$(12,720)	$161,220
Long-term liabilities	183,518	1,376	2,760		187,654
Minority interest		32,696	3,395	213	36,304
Stockholders equity	238,180	157,284	145,643	(62,383)	478,724
Total liabilities and stockholders equity	$ 59,918	$596,681	$282,193	$(74,890)	$863,902

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
As of December 31, 2003					
Cash and cash equivalents	$ 20,157	$ 2,646	$ 27,492	$	$ 50,295
Accounts receivable, net		117,209	56,470		173,679
Other current assets	35,329	21,467	11,334		68,130
Total current assets	55,486	141,322	95,296		292,104
Property, plant and equipment, net	27,841	123,894	69,924	2,738	224,397
Goodwill	1,483	187,848	96,947	300	286,578

Other assets	10,637	25,926	5,940	(25,709)	16,794
Total assets	$ 95,447	$478,990	$268,107	$(22,671)	$819,873
Current liabilities (including intercompany assets and liabilities)	$(261,412)	$315,138	$126,004	$(10,293)	$169,437
Long-term liabilities	42,951	1,243	2,746		46,940
Minority interest		30,091	2,347	213	32,651
Stockholders equity	313,908	132,518	137,010	(12,591)	570,845
Total liabilities and stockholders equity	$ 95,447	$478,990	$268,107	$(22,671)	$819,873

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Condensed Consolidating Income Statements

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the three months ended March 31, 2004					
Net revenue	$ 187	$ 187,654	$ 91,386	$ (1,199)	$ 278,028
Total operating costs and expenses	10,306	141,123	71,091	(1,199)	221,321
Income (loss) from operations	(10,119)	46,531	20,295		56,707
Interest expense, net	965				965
Minority interest		6,586	628		7,214
Provision (benefit) for income taxes	(4,212)	15,179	7,474		18,441
Net income (loss)	$ (6,872)	$ 24,766	$ 12,193	$	$ 30,087

Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total