MENTOR CORP /MN/
Form 10-Q
February 08, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2004

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. 0-7955

MENTOR CORPORATION
(Exact Name of Registrant as Specified in its Charter)

Minnesota (State or other jurisdiction of incorporation or organization)	41-0950791 (IRS Employer Identification No.)

201 Mentor Drive, Santa Barbara, California 93111
(Address of Principal Executive Offices) (Zip Code)
Registrant's telephone number including area code: 805/879-6000

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 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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes (X) No ( )

As of February 4, 2005 there were approximately 40,522,308 Common Shares, par value $.10, outstanding.

MENTOR CORPORATION

INDEX

PART I - FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

Mentor Corporation
Consolidated Balance Sheets
(Unaudited)

(in thousands)		December 31, 2004		March 31, 2004
Assets				
Current assets:				
Cash and cash equivalents	**$**	**60,666**	$	118,225
Marketable securities		**2,054**		193
Accounts receivable, net		**102,795**		106,016
Inventories		**78,184**		67,912
Deferred income taxes		**22,894**		22,488
Prepaid expenses and other		**20,172**		13,205
Total current assets		**286,765**		328,039
Property and equipment, net		**76,414**		77,529
Intangible assets, net		**36,782**		51,014
Goodwill, net		**24,661**		23,711
Long-term marketable securities and investments		**32,021**		8,326
Other assets		**8,527**		10,160
	$	**465,170**	$	498,779

See notes to condensed consolidated financial statements.

Mentor Corporation
Consolidated Balance Sheets
(Unaudited)

(in thousands)		December 31, 2004		March 31, 2004
Liabilities and shareholders' equity				
Current liabilities:				
Accounts payable	**$**	**33,639**	$	37,126
Warranty and related reserves		**24,886**		23,396
Accrued compensation		**18,938**		18,212
Short-term bank borrowings		**8,845**		10,012
Sales returns		**10,035**		11,797
Deferred revenue		**12,706**		6,915
Income taxes payable		**-**		285
Current portion of purchase price related to acquired technologies and acquisitions		**1,200**		1,864
Interest payable		**-**		1,187
Dividends payable		**6,890**		6,309
Accrued royalties		**720**		567
Other		**14,209**		12,260
Total current liabilities		**132,068**		129,930
Deferred income taxes		**2,752**		2,549
Long-term accrued liabilities		**9,351**		17,996
Convertible subordinated notes		**150,000**		150,000
Shareholders' equity:				
Common Stock, $.10 par value:				
Authorized - 150,000,000 shares; Issued and outstanding 40,502,707 shares at December 31, 2004; 42,059,136 shares at March 31, 2004;		**4,050**		4,206
Capital in excess of par value		**-**		-
Accumulated other comprehensive income		**30,887**		19,122
Retained earnings		**136,062**		174,976
		170,999		198,304
	$	**465,170**	$	498,779

See notes to condensed consolidated financial statements.

Mentor Corporation
Consolidated Statements of Income
Three Months Ended December 31, 2004 and 2003
(Unaudited)

(in thousands, except per share data)	Three Months Ended December 31, 2004		Three Months Ended December 31, 2003	
Net sales	**$**	**120,601**	$	106,502
Cost of sales		**42,856**		40,461
Gross profit		**77,745**		66,041
Selling, general and administrative expense		**45,353**		40,627
Research and development expense		**8,053**		7,216
		53,406		47,843
Operating income		**24,339**		18,198
Interest expense		**(1,346)**		(371)
Interest income		**683**		394
Other income, net		**432**		182
Income before income taxes		**24,108**		18,403
Income taxes		**7,779**		5,863
Net income	**$**	**16,329**	$	12,540
Basic earnings per share	**$**	**0.39**	$	0.27
Diluted earnings per share[1]	**$**	**0.34**	$	0.26[1]
Dividends per share	**$**	**0.17**	$	0.15
Weighted average shares outstanding				
Basic		**42,367**		45,769
Diluted[1]		**49,987**		48,807[1]

See notes to condensed consolidated financial statements.

[1] Diluted earnings per share and weighted average shares outstanding for the three-months ended December 31, 2003 have been restated to reflect the additional shares that would be issued upon conversion of our 2¾% convertible notes, in accordance with recently adopted Emerging Issue Task Force (EITF) Issue No. 04-8.

Mentor Corporation
Consolidated Statements of Income
Nine Months Ended December 31, 2004 and 2003
(Unaudited)

(in thousands, except per share data)	Nine Months Ended December 31, 2004		Nine Months Ended December 31, 2003	
Net sales	$	**351,812**	$	304,871
Cost of sales		**127,469**		115,395
Gross profit		**224,343**		189,476
Selling, general and administrative expense		**129,173**		110,205
Research and development expense		**24,636**		22,470
		153,809		132,675
Operating income		**70,534**		56,801
Interest expense		**(3,982)**		(681)
Interest income		**1,631**		1,113
Other income (expense), net		**249**		1,107
Income before income taxes		**68,432**		58,340
Income taxes		**21,915**		18,529
Net income	$	**46,517**	$	39,811
Basic earnings per share	$	**1.10**	$	0.86
Diluted earnings per share[1]	$	**0.98**[1]	$	0.82[1]
Dividends per share	$	**0.49**	$	0.32
Weighted average shares outstanding				
Basic		**42,360**		46,239
Diluted[1]		**50,169**[1]		48,588[1]

See notes to condensed consolidated financial statements.

[1] Diluted earnings per share and weighted average shares outstanding for the nine-months ended December 31, 2004 and 2003 have been restated to reflect the additional shares that would be issued upon conversion of our 2¾% convertible notes, in accordance with recently adopted Emerging Issue Task Force (EITF) Issue No. 04-8.

Mentor Corporation
Consolidated Statements of Cash Flows
Nine Months Ended December 31, 2004 and 2003
(Unaudited)

(in thousands)

	2004	2003
Operating Activities:		
Net income	$ 46,517	$ 39,811
Adjustments to derive cash flows from operating activities:		
Depreciation	11,222	9,770
Amortization	3,977	2,522
Deferred income taxes	908	(1,452)
Tax benefit from exercise of stock options	5,694	2,895
(Gain) loss on sale of assets	1,513	20
Imputed interest on long-term liabilities	15	194
(Gain) loss on long-term marketable securities	14	136
Changes in operating assets and liabilities:		
Accounts receivable	8,217	3,441
Inventories	(5,383)	(6,845)
Prepaid income taxes and other current assets	(6,316)	(3,725)
Accounts payable and accrued liabilities	710	263
Income taxes payable	(633)	171
Net cash provided by operating activities	66,455	47,201
Investing Activities:		
Purchases of property and equipment	(6,818)	(14,200)
Purchases of intangibles	(1,507)	(3,890)
Purchases of marketable securities	(144,192)	(28,331)
Sales of marketable securities	118,587	21,634
Acquisitions, net of cash acquired	-	(13,391)
Net cash used for investing activities	(33,930)	(38,178)
Financing Activities:		
Issuance of convertible notes, net of issuance costs	-	115,540
Sale of warrants	-	11,891
Repurchase of common stock	(79,773)	(68,895)
Proceeds from exercise of stock options	8,990	6,896
Dividends paid	(20,623)	(8,855)
Borrowings (repayments) under line of credit agreements, net	(518)	804
Net cash (used) provided by financing activities	(91,924)	57,381
Effect of currency exchange rates on cash and cash equivalents	1,840	1,066
Increase (decrease) in cash and cash equivalents	(57,559)	67,470
Cash and cash equivalents at beginning of year	118,225	105,840
Cash and cash equivalents at end of period	$ 60,666	$ 173,310

See notes to condensed consolidated financial statements.

MENTOR CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

Note A - Business Activity

Mentor Corporation (the "Company") was incorporated in April 1969. Unless the context indicates otherwise, when we refer to "Mentor," "we," "us," "our," or the "Company" in this Form 10-Q, we are referring to Mentor Corporation and its subsidiaries on a consolidated basis. We develop, manufacture and market a broad range of products serving the medical specialties market. Our products are utilized by three primary segments, aesthetic and general surgery (plastic and reconstructive surgery), surgical urology, and clinical and consumer healthcare. Aesthetic and general surgery products include surgically implantable prostheses for plastic and reconstructive surgery as well as capital equipment and consumables used for soft tissue aspiration or body contouring (liposuction). Surgical urology products include surgically implantable prostheses for the treatment of impotence, surgically implantable incontinence products, urinary care products and brachytherapy seeds for the treatment of prostate cancer. Clinical and consumer healthcare products include catheters and other products for the management of urinary incontinence and retention.

Note B - Summary of Significant Accounting Policies

The consolidated financial statements include the accounts of the Company and all of its subsidiaries in which a controlling interest is maintained. For those subsidiaries where the Company owns less than 100%, the outside shareholders' interests are treated as minority interests. All inter-company accounts and transactions have been eliminated. Certain prior year amounts in previously issued financial statements have been reclassified or restated to conform to the current year presentation.

Basis of Presentation

The financial information for the three and nine-months ended December 31, 2004 and 2003 is unaudited but includes all adjustments (consisting only of normally recurring accruals, unless otherwise indicated) that the Company considers necessary for a fair presentation of the results of operations for these periods. Interim results are not necessarily indicative of results for the full fiscal year.

Use of Estimates

Financial statements prepared in accordance with accounting principles generally accepted in the United States require management to make estimates and judgments that affect amounts and disclosures reported in the financial statements. Actual results could differ from those estimates. A discussion of the Company’s significant accounting policies is described in the “Application of Critical Accounting Policies” section of “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

Effects of Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued a revision to FAS No. 123, Share-Based Payment. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Statement 123(R) covers a wide range of share-based compensation arrangements and requires that the compensation cost related to these types of payment transactions be recognized in financial statements. Cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) becomes effective for period starting after June 15, 2005. The Company has not completed its analysis of the impact of the adoption of 123(R), however, the effect of the adoption on earnings per share is estimated to be the same as that shown in Note K – Stock Options.

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 151, Inventory Costs, which amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing. This amendment clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criteria specified in ARB 43 of “so abnormal”. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. This Statement is effective for financial statements for fiscal years beginning after June 15, 2005. The impact upon adoption of SFAS No. 151 is not expected to have a material impact on the results of operations or the financial position of the Company.

In September 2004, the Financial Accounting Standards Board (FASB) confirmed Emerging Issue Task Force (EITF) Issue No. 04-8, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share," with an effective date of December 15, 2004. The EITF reflects the Task Force’s conclusion that contingently convertible debt should be included in diluted earnings per share calculations regardless of whether or not the trigger price has been reached. The Company adopted EITF 04-8 in the quarter ending December 31, 2004 and retroactively restated the weighted average shares outstanding for diluted earnings per share for the three-months and nine-months ended December 31, 2003 and for the nine-months ended December 31, 2004. The impact of the EITF changed the diluted earnings per share calculation by increasing net income used in the numerator by the after tax amount of interest expense related to the convertible notes (approximately $800,000 per quarter), and increasing weighted average shares outstanding used in the denominator by approximately 5.1 million shares; the number of shares to be issued upon full conversion of the convertible notes. The effect of the restatement was a decrease in diluted earnings per share of approximately $.02 cents per share for the quarter ended December 31, 2004 and $0.06 cents per share for the nine-months ended December 31, 2004.

In March 2004, the Financial Accounting Standards Board (FASB) approved the consensus reached on the EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.” The objective of this Issue is to provide guidance for identifying impaired investments. EITF 03-1 also provides new disclosure requirements for investments that are deemed to be temporarily impaired. The accounting provisions of EITF 03-1 are effective for all reporting periods beginning after June 15, 2004, while the disclosure requirements are effective only for annual periods ending after June 15, 2004. We have evaluated the impact of the adoption of EITF 03-1 and do not believe it will be significant to our results of operations or financial position.

Note C - Interim Reporting

The Company's three quarterly interim reporting periods are each thirteen-week periods ending on the Friday nearest the end of the third calendar month of each calendar quarter. The fiscal year end remains March 31st. To facilitate ease of presentation, each interim period is shown as if it ended on the last day of the appropriate calendar month. The actual dates for each of the three interim quarters-end are shown below:

	Fiscal 2005	Fiscal 2004
First Quarter	July 2, 2004	June 27, 2003
Second Quarter	October 1, 2004	September 26, 2003
Third Quarter	December 31, 2004	January 2, 2004

The accompanying unaudited condensed consolidated financial statements for the three-month and nine-month periods ended December 31, 2004 and 2003 have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting only of normally recurring accruals, unless otherwise indicated) considered necessary for a fair presentation of the results of operations for the indicated periods have been included. Certain amounts recorded in previous periods have been reclassified or restated to conform to the current period presentation. Operating results for the three-month and nine-month periods ended December 31, 2004 are not necessarily indicative of the results for the full fiscal year.

The balance sheet at March 31, 2004 has been derived from the audited financial statements as of that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

The condensed consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended March 31, 2004.

Note D - Cash Equivalents, Marketable Securities, and Long-Term Marketable Securities and Investments

All highly liquid investments with maturities of three months or less at the date of purchase are considered to be cash equivalents.

The Company considers its marketable securities available-for-sale as defined in Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Realized gains and losses, and declines in value considered to be other than temporary, are included in income. The cost of securities sold is based on the specific identification method. For short-term marketable securities, there were no material realized or unrealized gains or losses, nor were there any material differences between estimated fair values, based on quoted market prices, and the costs of securities in the investment portfolio as of December 31, 2004, and March 31, 2004. Short-term investments, except auction rate securities, mature between three months and one year from the purchase date. The Company's short-term marketable securities consist primarily of money market mutual funds, U.S. state and municipal government and government agency obligations, auction rate securities, and investment grade corporate obligations, including commercial paper. Auction rate securities carry interest or dividend rates that reset every 28 days, but have contractual maturities of greater than one year.

The Company's long-term marketable securities and investments include investments in Federal Home Loan Bank and Mortgage Association bonds (FHLA bonds) with maturities of two to four years.

Available-for-sale investments at December 31, 2004 were as follows:

(in thousands)	**Adjusted Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Estimated Fair Value**
Cash balances				