THORATEC CORP
Form 10-Q
May 07, 2014
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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 29, 2014

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: 000-49798

THORATEC CORPORATION

(Exact name of registrant as specified in its charter)

California (State or other jurisdiction of incorporation or organization)	**94-2340464** (I.R.S. Employer Identification No.)
6035 Stoneridge Drive, Pleasanton, California (Address of principal executive offices)	**94588** (Zip Code)

(925) 847-8600

(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 x 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 x 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 x	Accelerated filer o
Non-accelerated filer o (Do not check if 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 x

As of April 25, 2014, the registrant had 56.8 million shares of common stock outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THORATEC CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(in thousands)

	March 29, 2014	December 28, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 108,653	$ 139,099
Short-term available-for-sale investments	186,535	166,691
Receivables, net of allowances of $2,396 in 2014 and $2,163 in 2013	77,220	71,418
Inventories	59,345	60,293
Deferred tax assets	15,161	15,161
Income tax receivable	9,781	5,733
Prepaid expenses and other assets	8,196	7,272
Total current assets	464,891	465,667
Property, plant and equipment, net	55,084	55,163
Goodwill	207,026	205,764
Purchased intangible assets, net	34,593	36,403
Long-term available-for-sale investments	4,247	4,234
Other long-term assets	23,301	24,476
Total Assets	$ 789,142	$ 791,707
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 15,923	$ 17,599
Accrued compensation	17,942	22,759
Contingent liabilities, current portion	9,189	6,962
Other accrued liabilities	29,989	27,001
Total current liabilities	73,043	74,321
Long-term deferred tax liability	1,876	2,224
Other long-term liabilities	12,317	12,105
Contingent liabilities, non-current portion (Note 2)	26,728	36,384
Total Liabilities	113,964	125,034
Shareholders equity:		
Common shares: no par, authorized 100,000; issued and outstanding 56,885 in 2014 and 56,904 in 2013		
Additional paid-in-capital	625,085	621,589
Retained earnings	62,548	57,587
Accumulated other comprehensive loss:	(12,455)	(12,503)

Total Shareholders Equity		675,178		666,673
Total Liabilities and Shareholders Equity	$	789,142	$	791,707

See notes to the unaudited condensed consolidated financial statements.

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THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in thousands, except per share data)

	Three Months Ended			
	March 29, 2014		March 30, 2013	
Product sales	$	125,697	$	117,725
Cost of product sales		40,026		35,073
Gross profit		85,671		82,652
Operating expenses:				
Selling, general and administrative		35,501		34,745
Research and development		23,339		24,513
Total operating expenses		58,840		59,258
Income from operations		26,831		23,394
Other income and (expense):				
Interest expense and other				(4)
Interest income and other		247		1,117
Income before income taxes		27,078		24,507
Income tax expense		8,839		6,337
Net income	$	18,239	$	18,170
Net Income per share:				
Basic	$	0.32	$	0.32
Diluted	$	0.32	$	0.31
Shares used to compute net income per share:				
Basic		56,840		57,486
Diluted		57,666		58,507

See notes to the unaudited condensed consolidated financial statements.

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THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

(in thousands)

	Three Months Ended March 29, 2014	Three Months Ended March 30, 2013
Net Income	$ 18,239	$ 18,170
Unrealized gains (losses) on investments (net of taxes of $(286) and $146 for the three months ended March 29, 2014 and March 30, 2013, respectively)	(1,411)	218
Foreign currency translation adjustments	1,459	(2,288)
Total other comprehensive income (loss)	48	(2,070)
Comprehensive Income	$ 18,287	$ 16,100

See notes to the unaudited condensed consolidated financial statements.

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THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Three Months Ended March 29, 2014	Three Months Ended March 30, 2013
Cash flows from operating activities:		
Net Income	$ 18,239	$ 18,170
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	4,163	4,495
Investment premium amortization, net	1,045	821
Allowance for (reduction in) bad debt	(599)	8
Non-cash interest income and other	405	380
Change in fair value of contingent consideration	(467)	
Tax benefit related to stock options	875	1,293
Share-based compensation expense	6,782	6,167
Excess tax benefits from share-based compensation	(898)	(1,271)
Loss (gain) on disposal of assets	(41)	57
Change in net deferred tax liability	(207)	(737)
Changes in assets and liabilities:		
Receivables	(5,026)	2,781
Inventories	507	(11,071)
Other current and non-current assets	(316)	(261)
Accounts payable	(1,030)	3,865
Income taxes, net	(2,458)	(1,913)
Other current and non-current liabilities	(3,545)	(9,288)
Net cash provided by operating activities	17,429	13,496
Cash flows from investing activities:		
Purchases of available-for-sale investments	(71,436)	(48,708)
Sales and maturities of available-for-sale investments	50,011	36,243
Purchases of property, plant and equipment	(2,157)	(3,883)
Net cash used in investing activities	(23,582)	(16,348)
Cash flows from financing activities:		
Payment of contingent consideration	(6,107)	(4,220)
Proceeds from stock option exercises	2,653	2,512
Excess tax benefits from share-based compensation	898	1,271
Repurchase and retirement of common shares	(22,285)	(5,802)
Net cash used in financing activities	(24,841)	(6,239)
Effect of exchange rate changes on cash and cash equivalents	548	(772)
Net decrease in cash and cash equivalents	(30,446)	(9,863)
Net cash and cash equivalents at beginning of period	139,099	101,322
Net cash and cash equivalents at end of period	$ 108,653	$ 91,459

Supplemental disclosure of consolidated cash flow information:				
Cash paid for income taxes	$	10,801	$	7,660
Supplemental disclosure of consolidated non-cash investing and financing activities:				
Transfers of equipment from inventory	$	650	$	594
Repurchases and retirement of common shares through other accrued liabilities	$	625	$	
Purchases of property, plant and equipment through accounts payable and accrued liabilities	$	410	$	445

See notes to the unaudited condensed consolidated financial statements.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Operations and Significant Accounting Policies

Basis of Presentation

The interim unaudited condensed consolidated financial statements of Thoratec Corporation (we, our, us, or the Company) have been prepared and presented in accordance with accounting principles generally accepted in the United States of America (GAAP) and the rules and regulations of the Securities and Exchange Commission (SEC), without audit, and reflect all adjustments necessary (consisting only of normal recurring adjustments) to present fairly our financial position, results of operations and cash flows as of and for the periods presented. Certain information and footnote disclosures normally included in our annual financial statements, prepared in accordance with GAAP, have been condensed or omitted. The accompanying financial statements should be read in conjunction with our fiscal 2013 consolidated financial statements, and the accompanying notes thereto, filed with the SEC in our 2013 Annual Report on Form 10-K for the fiscal year ended December 28, 2013 (the 2013 Annual Report). The operating results for any interim period are not necessarily indicative of the results that may be expected for any future period.

The preparation of our unaudited condensed consolidated financial statements necessarily requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities on the unaudited condensed consolidated balance sheet dates and the reported amounts of revenues and expenses for the periods presented. The actual amounts could differ from those estimated amounts.

Note 2. Acquisition of DuraHeart II

On June 30, 2013 (acquisition date), we acquired certain assets (the Purchased Assets) and assumed certain liabilities from Terumo Corporation (Terumo) related to the DuraHeart II Left Ventricular Assist System product line (DuraHeart II) previously under development by Terumo. Under the terms of the acquisition, we made an upfront cash payment to Terumo of $13.0 million, and will be obligated to make potential future milestone payments, based on regulatory approvals and product sales, of up to $43.5 million. Terumo also maintains the right to repurchase the Purchased Assets in the event that we do not fulfill certain conditions at various dates. As part of the agreement, we hired a team of Terumo employees. Additionally, we entered into a distribution partnership with Terumo, in which Terumo will commercialize DuraHeart II in Japan and potentially other parts of Asia, if and when local regulatory approvals are obtained.

The DuraHeart II acquisition was accounted for as a business combination by us. In connection with the acquisition, we recorded $2.0 million of acquisition-related costs, which were recognized in our consolidated statement of operations in fiscal 2013 within operating expenses. We also recorded $9.9 million of goodwill, equal to the amount by which the purchase consideration exceeded the fair value of the Purchased Assets. This goodwill was allocated to our sole operating segment and is deductible for U.S. income tax purposes. We will be obligated to pay potential post-closing cash milestone payments of $5.5 million and $10.5 million upon Conformité Européene (CE) Mark approval in Europe and U.S. Food and Drug Administration (FDA) approval, respectively, for the DuraHeart II device currently under development (collectively referred to as the regulatory milestones). Additional milestone payments totaling $27.5 million will become payable by us upon reaching various commercial sale milestones after the regulatory approvals are obtained (referred to as the commercial sales milestones). The fair value of the combined contingent consideration due upon achievement of the regulatory milestones and the commercial sales milestones was estimated to be $18.8 million at the acquisition date and has been recorded as a non-current liability, because such contingent consideration is expected to be settled no earlier than 2016.

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Total purchase price consideration was as follows (in thousands):

Cash paid at the acquisition closing date (June 30, 2013)	$	13,000
Estimated fair value of contingent consideration		18,800
Total estimated purchase price	$	31,800

We determined the initial fair value of the contingent consideration in connection with the regulatory and commercial sales milestones using various estimates, including probabilities of success, discount rates and the estimated amount of time until the conditions of the milestone payments are met. This fair value measurement was based on significant inputs not observable in the market, representing a Level 3 measurement within the fair value hierarchy (see Note 3 for more information about fair value measurements). The key assumptions used to determine the fair value of the contingent consideration at the acquisition date in connection with the regulatory milestones included a discount rate and probability-adjusted milestone payment date ranges. The key assumptions used to determine the fair value of contingent consideration at the acquisition date in connection with the commercial sales milestones included a discount rate and probability-weighted expected milestone payment date ranges based on the aggregate number of commercial units sold. In the three months ended March 29, 2014, the fair value of the contingent consideration decreased by $0.5 million as a result of changes in the probabilities of possible outcome, offset by accretion expense associated with the passage of time. The net change was reported as a decrease in research and development expense of $1.6 million, in part offset by an increase in selling, general and administrative expense of $1.1 million in the condensed consolidated statement of operations for the three months ended March 29, 2014.

Purchase Price Allocation as of the acquisition date is summarized as follows (in thousands):

Property, plant and equipment	$	8,900
Identifiable intangible assets:		
Favorable lease contract		600
IPR&D asset		12,400
Goodwill		9,900
Total estimated purchase price consideration		31,800
Less: Contingent consideration		18,800
Cash paid at the acquisition closing	$	13,000

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We recorded an IPR&D asset of $12.4 million, which represents an estimate of the fair value of the in-process technology related to the DuraHeart II device. The fair value of the IPR&D asset was determined using the multi-period excess earnings method which is equal to the present value of the incremental after-tax cash flows attributable to that intangible asset, discounted based on our best estimate of a market participant s after-tax weighted average cost of capital.

We recorded equipment totaling $8.9 million based on the fair value at the acquisition date. Of that amount, $8.1 million is related to certain equipment that is expected to be primarily used in the production of DuraHeart II units in anticipation of future clinical trials and throughout the commercialization of the product. Depreciation will commence upon production of the DuraHeart II units.

The following pro forma information presents the combined results of operations for the three months ended March 30, 2013 as if we had completed the DuraHeart II acquisition at the beginning of 2012. The pro forma financial information is provided for comparative purposes only and is not necessarily indicative of what actual results would have been had the acquisition occurred on the date indicated, nor does it give effect to synergies, cost savings, fair market value adjustments, immaterial depreciation expense and other changes expected to result from the acquisition. Accordingly, the pro forma financial results do not purport to be indicative of condensed consolidated results of operations as of the date hereof, for any period ended on the date hereof, or for any other future date or period.

		Three months Ended March 30, 2013
Product sales	$	117,725
Income before taxes		16,518
Net income		12,247

Note 3. Fair Value Measurements

Our financial assets and liabilities carried at fair value are primarily comprised of investments in money market funds, certificates of deposit, municipal and corporate bonds, commercial paper, variable demand notes, asset-backed securities, auction rate securities (ARS), forward contracts, certain investments held as assets under the deferred compensation plan, marketable equity securities and the contingent consideration in connection with acquisitions. The fair value accounting guidance requires that assets and liabilities be carried at fair value and classified in one of the following three categories:

Level 1: Quoted prices in active markets for identical assets or liabilities that we have the ability to access

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data such as quoted prices, interest rates and yield curves

Level 3: Inputs that are unobservable data points that are not corroborated by market data

We review the fair value hierarchy classification on a quarterly basis. Changes in the ability to observe valuation inputs may result in a reclassification of levels of certain securities within the fair value hierarchy. We recognize transfers into and out of levels within the fair value hierarchy in the period in which the actual event or change in circumstances that caused the transfer occurs. There were no transfers between Level 1, Level 2 and Level 3 during either of the three months ended March 29, 2014 or March 30, 2013.

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The following table represents the fair value hierarchy for our financial assets and financial liabilities measured at fair value on a recurring basis:

	Total Fair Value	Level 1	Level 2	Level 3
		(in thousands)		
As of March 29, 2014:				
Cash equivalents:				
Money market funds	$ 58,561	$ 58,561	$	$
Commercial paper	32,347		32,347	
Municipal bonds	3,820		3,820	
Short-term investments:				
Municipal bonds	154,094		154,094	
Asset-backed securities	3,470		3,470	
Corporate bonds	16,227		16,227	
Commercial paper	10,744		10,744	
Certificate of deposit	2,000		2,000	
Prepaid expenses and other assets:				
Foreign exchange contracts	1,113		1,113	
Long-term investments:				
Auction rate securities	4,247			4,247
Other long-term assets:				
Investments included in our deferred compensation plan	2,017		2,017	
Marketable equity securities	2,397	2,397		
Other accrued liabilities:				
Foreign exchange contracts	1,589		1,589	
Contingent consideration (current and non-current portions)	$ 35,917	$	$	$ 35,917

	Total Fair Value	Level 1	Level 2	Level 3
		(in thousands)		
As of December 28, 2013:				
Cash equivalents:				
Money market funds	$ 97,200	$ 97,200	$	$
Commercial paper	13,899		13,899	
Short-term investments:				
Municipal bonds	142,486		142,486	
Variable demand notes	6,700		6,700	
Corporate bonds	5,507		5,507	
Commercial paper	9,998		9,998	
Certificate of deposit	2,000		2,000	
Prepaid expenses and other assets:				
Foreign exchange contracts	592		592	
Long-term investments:				
Auction rate securities	4,234			4,234
Other long-term assets:				
Investments included in our deferred compensation plan	1,700		1,700	
Marketable equity securities	4,019	4,019		
Other accrued liabilities:				
Foreign exchange contracts	156		156	
	$ 43,346	$	$	$ 43,346

Contingent consideration (current and non-current portions)

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Financial assets and liabilities are considered Level 2 when their fair values are determined using inputs that are observable in the market or can be derived principally from or corroborated by observable market data such as pricing for similar securities, recently executed transactions, cash flow models with yield curves and benchmark securities. Our Level 2 financial assets and liabilities include short-term investments, foreign exchange instruments and certain of our deferred compensation plan securities. In addition, Level 2 financial instruments are valued using comparisons to like-kind financial instruments and models that use readily observable market data as their basis.

Financial assets and liabilities are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques, and at least one significant model assumption or input is unobservable. Level 3 financial assets and liabilities include the following:

Auction rate securities Due to limited market activity the determination of fair value requires significant judgment or estimation. These available-for-sale debt securities were valued using a discounted cash-flow model over a five-year period based on estimated interest rates, the present value of future principal payments, and interest payments discounted at rates considered to reflect the current market conditions and the credit quality of auction rate securities.

Contingent consideration The fair value of the contingent consideration related to the acquisition of the medical business of Levitronix LLC (Levitronix Medical) in August 2011 requires significant management judgment or estimation and is calculated using the income approach, using various revenue assumptions and applying a probability to each outcome. The fair value of the contingent consideration is remeasured at the end of each reporting period with the change in fair value recorded within operating expense in our condensed consolidated statements of operations. Actual amounts paid may differ from the obligations recorded. The accretion of interest expense was not significant for all periods presented. Refer to Note 2 for a discussion of the fair value of the contingent consideration associated with the DuraHeart II acquisition.

Available-for-sale investments are carried at fair value and are included in the tables above under short- and long-term investments. The aggregate market value, cost basis and gross unrealized gains and losses of available-for-sale investments by major security type are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(in thousands)		
As of March 29, 2014:				