THORATEC CORP
Form 10-Q
November 06, 2014

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 September 27, 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	**94-2340464**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
6035 Stoneridge Drive, Pleasanton, California	**94588**
(Address of principal executive offices)	(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 October 24, 2014, the registrant had 55.0 million shares of common stock outstanding.

THORATEC CORPORATION

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DuraHeart is a registered trademark of Terumo Corporation.

PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

THORATEC CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(in thousands)

	September 27, 2014	December 28, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$ 123,684	$ 139,099
Short-term available-for-sale investments	124,880	166,691
Receivables, net of allowances of $1,569 in 2014 and $2,163 in 2013	62,468	71,418
Inventories	71,541	60,293
Deferred tax assets	15,257	15,161
Income tax receivable	15,975	5,733
Prepaid expenses and other assets	9,922	7,272
Total current assets	423,727	465,667
Property, plant and equipment, net	54,943	55,163
Goodwill	231,465	205,764
Purchased intangible assets, net	60,434	36,403
Long-term available-for-sale investments	4,358	4,234
Other long-term assets	25,687	24,476
Total Assets	$ 800,614	$ 791,707
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 15,948	$ 17,599
Accrued compensation	20,491	22,759
Warranty and related accrual	18,952	9,899
Contingent liabilities, current portion	17,040	6,962
Other accrued liabilities	15,722	17,102
Total current liabilities	88,153	74,321
Long-term deferred tax liability	4,054	2,224
Other long-term liabilities	12,006	12,105
Contingent liabilities, non-current portion (Note 2)	44,079	36,384
Total Liabilities	148,292	125,034
Shareholders equity:		
Common shares: no par, authorized 100,000; issued and outstanding 55,133 in 2014 and 56,904 in 2013		
Additional paid-in-capital	617,968	621,589
Retained earnings	51,432	57,587
Accumulated other comprehensive loss:	(17,078)	(12,503)
Total Shareholders Equity	652,322	666,673
Total Liabilities and Shareholders Equity	$ 800,614	$ 791,707

See notes to the unaudited condensed consolidated financial statements.

THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Product sales	$ 105,839	$ 126,444	$ 349,599	$ 374,648
Cost of product sales	42,627	40,958	116,960	117,031
Gross profit	63,212	85,486	232,639	257,617
Operating expenses:				
Selling, general and administrative	35,004	37,679	105,982	107,348
Research and development	26,097	25,469	72,484	71,488
Total operating expenses	61,101	63,148	178,466	178,836
Income from operations	2,111	22,338	54,173	78,781
Other income and (expense):				
Interest expense and other	(22)		(24)	(4)
Interest income and other	(1,105)	569	(299)	1,899
Income before income taxes	984	22,907	53,850	80,676
Income tax (expense) benefit	1,913	(4,003)	(15,301)	(20,413)
Net income	$ 2,897	$ 18,904	$ 38,549	$ 60,263
Net Income per share:				
Basic	$ 0.05	$ 0.33	$ 0.68	$ 1.05
Diluted	$ 0.05	$ 0.32	$ 0.67	$ 1.03
Shares used to compute income per share:				
Basic	55,733	57,427	56,430	57,447
Diluted	56,111	58,234	57,119	58,400

See notes to the unaudited condensed consolidated financial statements.

THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(unaudited)

(in thousands)

	Three Months Ended		Nine Months Ended	
	September 27, 2014	September 28, 2013	September 27, 2014	September 28, 2013
Net income	$ 2,897	$ 18,904	$ 38,549	$ 60,263
Unrealized gains (losses) on investments (net of taxes (benefits) of $27 and $1,225 for the three months ended September 27, 2014 and September 28, 2013, respectively, and ($257) and $1,230 for the nine months ended September 27, 2014 and September 28, 2013, respectively)	40	1,858	(1,367)	1,851
Foreign currency translation adjustments	(3,886)	1,216	(3,208)	(460)
Total other comprehensive income (loss)	(3,846)	3,074	(4,575)	1,391
Comprehensive income (loss)	$ (949)	$ 21,978	$ 33,974	$ 61,654

See notes to the unaudited condensed consolidated financial statements.

THORATEC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Nine Months Ended September 27, 2014	Nine Months Ended September 28, 2013
Cash flows from operating activities:		
Net Income	$ 38,549	$ 60,263
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	12,097	13,841
Fixed assets write down	520	1,961
Investment premium amortization, net	3,021	2,557
Reduction in bad debt reserve	(1,321)	(199)
Non-cash interest income (expense) and other	2,578	(151)
Tax benefit related to stock options	905	1,551
Change in fair value of contingent consideration	(965)	3,913
Share-based compensation expense	21,586	20,226
Excess tax benefits from share-based compensation	(1,082)	(1,750)
Loss on disposal of assets	707	70
Change in net deferred tax liability	(1,281)	(515)
Changes in assets and liabilities:		
Receivables	9,393	3,957
Inventories	(13,455)	(20,578)
Other current and non-current assets	1,163	1,499
Accounts payable	(688)	(92)
Income taxes, net	(10,889)	(1,650)
Other current and non-current liabilities	7,214	1,548
Net cash provided by operating activities	68,052	86,451
Cash flows from investing activities:		
Purchases of available-for-sale investments	(112,771)	(132,351)
Sales and maturities of available-for-sale investments	150,578	108,019
Acquisition of a business, net of cash acquired	(34,508)	(13,000)
Purchases of property, plant and equipment	(6,835)	(6,916)
Non-marketable equity investment	(1,500)	
Net cash used in investing activities	(5,036)	(44,248)
Cash flows from financing activities:		
Payment of contingent consideration	(6,107)	(4,220)
Proceeds from stock option exercises	2,889	6,635
Proceeds from stock issued under employee stock purchase plan	2,800	2,536
Excess tax benefits from share-based compensation	1,082	1,750
Repurchase and retirement of common shares	(79,229)	(47,089)
Net cash used in financing activities	(78,565)	(40,388)
Effect of exchange rate changes on cash and cash equivalents	134	(294)
Net increase (decrease) in cash and cash equivalents	(15,415)	1,521
Net cash and cash equivalents at beginning of period	139,099	101,322
Net cash and cash equivalents at end of period	$ 123,684	$ 102,843

Supplemental disclosure of consolidated cash flow information:				
Cash paid for taxes	$	26,804	$	21,237
Supplemental disclosure of consolidated non-cash investing and financing activities:				
Transfers of equipment from inventory	$	1,496	$	1,754
Purchases of property, plant and equipment through accounts payable and accrued liabilities	$	180	$	670
Acquisitions of Apica (2014) and DuraHeart II (2013):				
Contingent consideration included in contingent liabilities, non-current portion	$	25,700	$	18,800
Acquisition of business payment included in other accrued liabilities	$	606	$	

See notes to the unaudited condensed consolidated financial statements.

THORATEC CORPORATION

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 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.

Recent Accounting Pronouncements

In August 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-15, *Presentation of Financial Statements-Going Concern* (Subtopic 205-40). This ASU provides guidance to determine when and how to disclose going-concern uncertainties in the financial statements. The new standard requires management to perform interim and annual assessments of an entity s ability to continue as a going concern within one year of the date that the financial statements are issued. An entity must provide certain disclosures if conditions or events raise substantial doubt about the entity s ability to continue as a going concern. The standard will be effective for the Company starting in fiscal 2017. We do not expect the adoption of this ASU to have an impact on our condensed consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-10, *Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation,* which eliminates the conditions that a development stage entity may be considered a variable interest entity (VIE) and requires that an equity investment to be evaluated both a qualitatively and quantitatively in accordance with Accounting Standard Codification 810-25-45 through 47 to determine whether the equity investment qualifies as a VIE. This standard is effective for annual periods beginning on or after December 15, 2014. We have not yet evaluated the impact of the adoption of this ASU on our condensed consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), which provides guidance for revenue recognition. This ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets. The guidance in this ASU supersedes the revenue recognition requirements in Topic 605, *Revenue Recognition*, and most industry-specific guidance. This ASU also supersedes some cost guidance included in Subtopic 605-35, *Revenue Recognition-Construction-Type and Production-Type Contracts*. The standard will be effective for the Company starting in fiscal 2017. We have not yet evaluated the impact of the adoption of this ASU on our condensed consolidated financial statements.

In April 2014, the FASB issued ASU No. 2014-08, *Presentation of Financial Statements* (Topic 205) and *Property, Plant, and Equipment* (Topic 360): *Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*, which raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. This standard is effective for annual periods beginning on or after December 15, 2014. Early adoption is permitted but only for disposals that have not been reported in financial statements previously issued. We are currently evaluating the impact of this ASU, however we do not expect it would have any significant impact on our condensed consolidated financial statements.

Note 2. Acquisitions and Acquisition-Related Items

Acquisitions in the nine months ended September 27, 2014 and September 27, 2013 were accounted for as business combinations. In accordance with authoritative guidance on business combination accounting, the assets and liabilities of the acquired companies were recorded as of the acquisition date, at their respective fair values, and are consolidated within our condensed consolidated financial statements. The results of operations related to each company acquired have been included in our consolidated statements of earnings since the date each company was acquired. All acquisition-related costs are expensed and recorded in selling, general and administrative expenses in our condensed consolidated statement of operations for the periods presented.

Apica Acquisition in 2014

On July 2, 2014, we acquired all of the outstanding equity interests of Apica Cardiovascular Limited (Apica) and certain related subsidiaries from the former stockholders of Apica (the Apica Acquisition). Under the terms of the Apica Acquisition, the initial purchase consideration was approximately $35.1 million (net of acquired cash and inclusive of the settlement of existing debt and

Apica s direct acquisition-related transaction costs) and we will be obligated to make potential future milestone payments (contingent consideration), based on regulatory approvals and commercial sales, of up to $40.0 million. Total purchase price allocation was estimated at $60.8 million, including the initial purchase consideration of approximately $35.1 million and the estimated fair values for contingent consideration totaling $25.7 million, which was recorded as a non-current liability because such contingent consideration is expected to be settled no earlier than 2016. Prior to the acquisition, Apica was developing a surgical implantation system (SIS) to improve the apical access and attachment of a Left Ventricular Assist Device to the apex of the heart. Thoratec plans to couple the SIS with our HeartMate product line with the intention to obtain regional regulatory approvals for commercialization. In addition, Apica had developed the apical access, stabilization, and closure (ASC) device, which is commercially sold in Europe and is used for transapical valve procedures. We incurred $2.1 million of acquisition-related costs in connection with the Apica Acquisition in the nine months ended September 27, 2014.

The preliminary purchase price allocation as of the acquisition date is summarized as follows (in thousands):

Current assets (excluding cash)	$	548
Identifiable intangible assets:		
Developed technology (ASC)		5,300
IPR&D asset (SIS)		26,500
Goodwill		31,381
Total assets		63,729
Less: Liabilities assumed		(291)
Deferred tax liability		(2,624)
Total estimated purchase price consideration		60,814
Less: Contingent consideration		(25,700)
Cash paid or payable at the acquisition closing	$	35,114

We recorded an IPR&D asset of $26.5 million, which represents an estimate of the fair value of the in-process technology related to the SIS 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, using a discount rate based on our best estimate of a market participant s after-tax weighted average cost of capital. We also recorded a developed technology intangible asset of $5.3 million, which represents the estimated fair value of the technology associated with the ASC device. The fair value of the developed technology intangible asset was determined using the replacement cost method, which represents what a market participant s estimated cost would be to obtain or develop the technology in its current state. The replacement cost method was utilized because of limited market opportunities associated with the ASC technology. The developed technology intangible asset related to the ASC device will be amortized over an estimated life of five years.

The goodwill of $31.4 million equals to the amount by which the purchase consideration exceeded the fair value of the purchased assets and was allocated to our sole operating segment (Cardiovascular) and is not deductible for income tax purposes. Net deferred tax liabilities of $2.6 million were recorded for certain book to tax differences. The operating results of Apica from the date of acquisition, including $0.1 million in revenue from the ASC device and $0.8 million net loss, are included in our condensed consolidated statement of operations for the three- and nine-month period ended September 27, 2014.

The following unaudited pro forma information presents the combined results of operations for the nine months ended September 27, 2014 and September 28, 2013 as if the Apica Acquisition had been completed as of the beginning of 2013. Actual 2014 acquisition-related transaction costs of $2.1 million were excluded from the 2014 pro forma results below and included in the 2013 pro forma results as if these costs were incurred during the 2013 period. All other adjustments to the pro forma results in 2014 and 2013 were not significant. The pro forma results do not reflect operating efficiencies or potential cost savings which may result from the consolidation of operations. The pro forma financial information is provided for comparative purposes only and does not purport to be indicative of condensed consolidated results of operations for the period ended on September 27, 2014, or for any other future period.

	Nine Months Ended September 27, 2014	Nine Months Ended September 28, 2013
	(in thousands)	
Product sales	$ 349,689	$ 374,648
Income before taxes	52,897	76,094
Net income	37,867	56,841

DuraHeart II Acquisition in 2013

On June 30, 2013, 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 (the DuraHeart II Acquisition). Under the terms of the DuraHeart II Acquisition, the initial purchase consideration was $13.0 million and we will be obligated to make potential future milestone payments, based on regulatory approvals and product sales, of up to $43.5 million. Total purchase price allocation was estimated at $31.8 million, including the initial purchase consideration of $13.0 million and the estimated fair values for contingent consideration totaling $18.8 million, which was recorded as a non-current liability because such contingent consideration is expected to be settled no earlier than 2016. As part of the agreement, Terumo also maintains the right to repurchase the Purchased Assets in the event that we do not fulfill certain conditions by specified dates. 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. We incurred $2.0 million of acquisition-related costs in connection with the DuraHeart II Acquisition in the nine months ended September 28, 2013. The goodwill of $9.9 million equals to the amount by which the purchase consideration exceeded the fair value of the purchased assets and was allocated to our sole operating segment and is deductible for U.S. income tax purposes.

The 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

The following pro forma information presents the combined results of operations for the nine months ended September 28, 2013 as if we had completed the DuraHeart II acquisition at the beginning of 2012. Actual 2013 acquisition-related transaction costs of $2.0 million were excluded from the 2013 pro forma results below as if these costs were incurred during the 2012 period. All other adjustments to the pro forma results in 2013 were not significant. The pro forma financial information is provided for comparative purposes only and does not purport to be indicative of condensed consolidated results of operations for the period ended on September 28, 2013, or for any other future period.

		Nine months Ended September 28, 2013
Product sales	$	374,648
Income before taxes		65,922
Net income		49,242

Contingent Considerations

The Company s acquisitions of Apica and DuraHeart II include payments of future contingent consideration upon the achievement of certain regulatory approvals and commercial sales milestones. With respect to each acquisition, 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 each contingent consideration associated with the regulatory milestones at the acquisition date included a discount rate and probability-adjusted milestone payment date ranges. The key assumptions used to determine the fair value of each contingent consideration associated with the commercial sales milestones at the acquisition date included a discount rate and probability-weighted expected milestone payment date ranges based on the aggregate number of commercial units sold.

The fair value of these payments of future contingent considerations are remeasured at each reporting period with the change in fair value recognized within operating expense in our condensed consolidated statements of operations. We measure the liabilities on a recurring basis using Level 3 inputs. See Note 3 for further information regarding fair value measurements.

- In the first nine months of 2014, the fair value of the Apica contingent consideration increased by $0.3 million, in which $0.2 million was reported as research and development (R&D) expense and $0.1 million was reported as selling, general and administrative (SG&A) expense. The overall increase was a result of accretion expense associated with the passage of time since the acquisition date.

- In the first nine months of 2014, the fair value of the DuraHeart II contingent consideration decreased by $3.0 million ($2.0 million reported as R&D expense and $1.0 million reported as SG&A expense) as a result of changes in the probabilities of possible outcomes, offset by accretion expense. In the first nine months of 2013, the fair value increased by $0.3 million ($0.1 million reported as R&D expense and $0.2 million reported as SG&A expense) as a result of accretion expense.

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 the first nine months of 2014 or first nine months of 2013.

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 September 27, 2014:				
Cash equivalents:				

Money market funds	$	85,886	$	85,886	$		$	
Commercial paper		10,729				10,729		
Municipal bonds		8,202				8,202		
Short-term investments:								
Municipal bonds		94,459				94,459		
Asset-backed securities		2,387				2,387		
Corporate bonds		20,237				20,237		
Commercial paper		7,797				7,797		
Prepaid expenses and other assets:								
Foreign exchange contracts		3,870				3,870		
Long-term investments:								
Auction rate securities		4,358						4,358
Other long-term assets:								
Investments included in our deferred compensation plan		1,526				1,526		
Marketable equity securities		2,375		2,375				
Other accrued liabilities:								
Foreign exchange contracts		505				505		
Contingent consideration (current and non-current portions)	$	61,119	$		$		$	61,119