

DAVITA INC
Form 10-Q
May 03, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

For the Quarterly Period Ended

March 31, 2007

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

Commission File Number: 1-14106

DAVITA INC.

601 Hawaii Street

El Segundo, California 90245

Telephone number (310) 536-2400

Delaware
(State of incorporation)

51-0354549
(I.R.S. Employer Identification No.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of April 30, 2007, the number of shares of the Registrant's common stock outstanding was approximately 105.3 million shares and the aggregate market value of the common stock outstanding held by non-affiliates based upon the closing price of these shares on the New York Stock Exchange was approximately \$5.7 billion.

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DAVITA INC.

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

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DAVITA INC.
CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(dollars in thousands, except per share data)

	Three months ended March 31,	
	2007	2006
Net operating revenues	\$ 1,278,166	\$ 1,163,188
Operating expenses and charges:		
Patient care costs	881,585	817,773
General and administrative	113,221	104,168
Depreciation and amortization	45,790	41,891
Provision for uncollectible accounts	33,635	30,080
Minority interests and equity income, net	10,618	7,201
Total operating expenses and charges	1,084,849	1,001,113
Operating income	193,317	162,075
Debt expense	(68,870)	(70,459)
Other income	3,195	3,874
Income from continuing operations before income taxes	127,642	95,490
Income tax expense	51,060	37,710
Income from continuing operations	76,582	57,780
Discontinued operations		
Loss on disposal of discontinued operations, net of tax		(311)
Net income	\$ 76,582	\$ 57,469
Earnings per share:		
Basic earnings per share from continuing operations	\$ 0.73	\$ 0.56
Basic earnings per share	\$ 0.73	\$ 0.56
Diluted earnings per share from continuing operations	\$ 0.72	\$ 0.55
Diluted earnings per share	\$ 0.72	\$ 0.55
Weighted average shares for earnings per share:		
Basic	105,013,140	102,581,455
Diluted	106,739,216	105,388,419

See notes to condensed consolidated financial statements.

Table of Contents**DAVITA INC.****CONSOLIDATED BALANCE SHEETS****(unaudited)****(dollars in thousands, except per share data)**

	March 31,	December 31,
	2007	2006
<u>ASSETS</u>		
Cash and cash equivalents	\$ 356,384	\$ 310,202
Short-term investments	5,815	4,734
Accounts receivable, less allowance of \$177,458 and \$171,757	906,510	932,385
Inventories	69,452	89,119
Other receivables	146,180	148,842
Other current assets	28,500	25,124
Deferred income taxes	235,191	199,090
Total current assets	1,748,032	1,709,496
Property and equipment, net	854,797	849,966
Amortizable intangibles, net	194,741	203,721
Investments in third-party dialysis businesses	1,823	1,813
Long-term investments	33,778	13,174
Long-term assets	41,735	45,793
Goodwill	3,663,091	3,667,853
	\$ 6,537,997	\$ 6,491,816
<u>LIABILITIES AND SHAREHOLDERS' EQUITY</u>		
Accounts payable	\$ 205,299	\$ 251,686
Other liabilities	441,583	473,219
Accrued compensation and benefits	302,689	341,766
Current portion of long-term debt	34,133	20,871
Income taxes payable	59,342	24,630
Total current liabilities	1,043,046	1,112,172
Long-term debt	3,721,373	3,730,380
Other long-term liabilities	54,398	50,076
Alliance and product supply agreement, net	102,255	105,263
Deferred income taxes	135,286	125,642
Minority interests	127,496	122,359
Commitments and contingencies		
Shareholders' equity:		
Preferred stock (\$0.001 par value, 5,000,000 shares authorized; none issued)		
Common stock (\$0.001 par value, 195,000,000 shares authorized; 134,862,283 shares issued; 105,200,346 and 104,636,608 shares outstanding)	135	135
Additional paid-in capital	647,240	630,091
Retained earnings	1,210,094	1,129,621
Treasury stock, at cost (29,661,937 and 30,225,675 shares)	(517,093)	(526,920)
Accumulated other comprehensive income	13,767	12,997
Total shareholders' equity	1,354,143	1,245,924

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\$ 6,537,997 \$ 6,491,816

See notes to condensed consolidated financial statements.

Table of Contents**DAVITA INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)****(dollars in thousands)**

	Three months ended March 31,	
	2007	2006
Cash flows from operating activities:		
Net income	\$ 76,582	\$ 57,469
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	45,790	41,891
Stock-based compensation expense	7,702	5,692
Tax benefits from stock option exercises	6,307	19,515
Excess tax benefits from stock-based compensation	(5,426)	(18,532)
Deferred income taxes	(2,194)	(2,425)
Minority interests in income of consolidated subsidiaries	10,828	8,104
Distributions to minority interests	(10,106)	(5,180)
Equity investment income	(210)	(903)
Loss (gain) on disposal of discontinued operation and other dispositions	1,552	(663)
Non-cash debt and non-cash rent charges	6,946	5,321
Changes in operating assets and liabilities, other than from acquisitions and divestitures:		
Accounts receivable	25,875	(5,558)
Inventories	19,667	(18,911)
Other receivables and other current assets	(4,471)	(17,850)
Other long-term assets	(1,873)	(1,210)
Accounts payable	(46,387)	(32,723)
Accrued compensation and benefits	(33,988)	5,223
Other current liabilities	(31,636)	(1,350)
Income taxes	26,389	(63,828)
Other long-term liabilities	(3,316)	2,354
Net cash provided by (used in) operating activities	88,031	(23,564)
Cash flows from investing activities:		
Purchase of investments	(20,975)	
Additions of property and equipment, net	(49,444)	(47,991)
Acquisitions and purchases of other ownership interests	(189)	(22,845)
Proceeds from divestitures and asset sales	98	17,734
Proceeds from sale of investments	6,236	
Investments in and advances to affiliates, net	4,650	2,635
Intangible assets	(55)	(5,015)
Net cash used in investing activities	(59,679)	(55,482)
Cash flows from financing activities:		
Borrowings	3,898,955	785,231
Payments on long-term debt	(3,894,640)	(898,443)
Deferred financing costs	(4,048)	(2)
Excess tax benefits from stock-based compensation	5,426	18,532
Stock option exercises and other share issuances, net	12,137	21,063

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Net cash provided by (used in) financing activities	17,830	(73,619)
Net increase (decrease) in cash and cash equivalents	46,182	(152,665)
Cash and cash equivalents at beginning of period	310,202	431,811
Cash and cash equivalents at end of period	\$ 356,384	\$ 279,146

See notes to condensed consolidated financial statements.

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DAVITA INC.
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
AND
COMPREHENSIVE INCOME
(unaudited)
(dollars and shares in thousands)

	Common stock		Additional paid-in capital	Retained earnings	Treasury stock		Accumulated other comprehensive income	Total
	Shares	Amount			Shares	Amount		
Balance at December 31, 2005	134,862	135	569,751	839,930	(32,927)	(574,013)	14,806	850,609
Comprehensive income:								
Net income				289,691				289,691
Unrealized gain on interest rate swaps, net of tax							7,862	7,862
Less reclassification of net swap valuation gains into net income, net of tax							(9,671)	(9,671)
Total comprehensive income								287,882
Stock purchase shares issued			1,861		80	1,403		3,264
Stock unit shares issued			(1,860)		160	2,790		930
Stock option shares issued			(5,023)		2,461	42,900		37,877
Stock-based compensation expense			26,389					26,389
Tax benefits from stock awards exercised			38,973					38,973
Balance at December 31, 2006	134,862	135	630,091	1,129,621	(30,226)	(526,920)	12,997	1,245,924
Comprehensive income:								
Net income				76,582				76,582
Unrealized (loss) on interest rate swaps, net of tax							(748)	(748)
Less reclassification of net swap valuation gains into net income, net of tax							(2,728)	(2,728)
Unrealized gain on investments, net of tax							4,246	4,246
Total comprehensive income								77,352
Cumulative effect of change in accounting principal SFAS Interpretation No. (FIN) 48				3,891				3,891
Stock purchase shares issued			3,831		124	2,160		5,991
Stock unit shares issued			(626)		50	876		250
Stock options exercised			543		390	6,791		7,334
Stock-based compensation expense			7,702					7,702
Tax benefits from stock awards exercised			5,699					5,699
Balance at March 31, 2007	134,862	\$ 135	\$ 647,240	\$ 1,210,094	(29,662)	\$ (517,093)	\$ 13,767	\$ 1,354,143

See notes to condensed consolidated financial statements.

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(dollars in thousands, except per share data)

Unless otherwise indicated in this Quarterly Report on Form 10-Q the Company , we , us , our and similar terms refer to DaVita Inc. and its consolidated subsidiaries.

1. Condensed consolidated interim financial statements

The condensed consolidated interim financial statements included in this report are prepared by the Company without audit. In the opinion of management, all adjustments consisting only of normal recurring items necessary for a fair presentation of the results of operations are reflected in these consolidated interim financial statements. All significant intercompany accounts and transactions have been eliminated. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. The most significant estimates and assumptions underlying these financial statements and accompanying notes generally involve revenue recognition and provisions for uncollectible accounts, impairments and valuation adjustments, accounting for income taxes, variable compensation accruals, purchase accounting valuation estimates and stock-based compensation. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the operating results for the full year. The consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006. Prior year balances and amounts have been classified to conform to the current year presentation.

2. Earnings per share

Basic net income per share is calculated by dividing net income by the weighted average number of common shares and vested stock units outstanding. Diluted net income per share includes the dilutive effect of outstanding stock options, stock appreciation rights and unvested stock units (under the treasury stock method).

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

The reconciliations of the numerators and denominators used to calculate basic and diluted net income per share are as follows:

	Three months ended March 31,	
	2007	2006
	(shares in thousands)	
Basic:		
Income from continuing operations	\$ 76,582	\$ 57,780
Loss on disposal of discontinued operations, net of tax		(311)
Net income	\$ 76,582	\$ 57,469
Weighted average shares outstanding during the period	104,995	102,558
Vested stock units	18	23
Weighted average shares for basic earnings per share calculations	105,013	102,581
Basic earnings per share from continuing operations, net of tax	\$ 0.73	\$ 0.56
Loss on disposal of discontinued operations, net of tax		
Basic net income per share	\$ 0.73	\$ 0.56
Diluted:		
Income from continuing operations	\$ 76,582	\$ 57,780
Loss on disposal of discontinued operations, net of tax		(311)
Net income for diluted earnings per share calculation	\$ 76,582	\$ 57,469
Weighted average shares outstanding during the period	104,995	102,558
Vested stock units	18	23
Assumed incremental shares from stock plans	1,726	2,807
Weighted average shares for diluted earnings per share calculation	106,739	105,388
Diluted earnings per share from continuing operations, net of tax	\$ 0.72	\$ 0.55
Loss on disposal of discontinued operations, net of tax		
Diluted net income per share	\$ 0.72	\$ 0.55

Shares associated with stock options and stock appreciation rights that have exercise or base prices greater than the average market price of shares outstanding during the period were not included in the computation of diluted earnings per share because they were anti-dilutive. These excluded shares were as follows:

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	Three months ended	
	March 31,	
	2007	2006
Stock award shares not included in computation (shares in 000 s)	1,066	77
Exercise price range of shares not included in computation:		
Low	\$ 54.15	\$ 56.92
High	\$ 60.21	\$ 60.21

Table of Contents**DAVITA INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)****(dollars in thousands, except per share data)****3. Stock-based compensation**

Under SFAS No. 123(R), stock-based compensation recognized during a period is based on the estimated grant-date fair value of the portion of the stock-based awards vesting during that period, adjusted for expected forfeitures. Stock-based compensation recognized in these condensed consolidated financial statements for 2007 includes compensation cost for stock-based awards granted prior to, but not fully vested as of, December 31, 2005 and subsequent stock-based awards granted through March 31, 2007. For the first three months of 2006 stock-based compensation includes compensation cost for stock-based awards granted prior to, but not fully vested as of December 31, 2005 and stock-based awards granted in the first three months of 2006. Prior to 2006, the Company recognized the effect of stock unit forfeitures as they occurred, and the effect of transitioning to recognition of expense based on expected forfeitures was insignificant. Shares issued upon exercise of stock awards are generally issued from shares in treasury. The Company has utilized the Black-Scholes-Merton valuation model for estimating the grant-date fair value of stock options and stock-settled stock appreciation rights granted in 2007 and all prior periods. During the first quarter of 2007, the Company granted 2,795,000 stock options and stock-settled appreciation rights with a grant-date fair value of \$38,697, and with a weighted-average expected life of approximately 3.75 years.

For the three months ended March 31, 2007 and March 31, 2006, the Company recognized \$7,702 and \$5,692, respectively, in stock-based compensation expense for stock options, stock-settled stock appreciation rights, stock units and discounted employee stock plan purchases, which is primarily included in general and administrative expenses in continuing operations. The estimated tax benefit recorded for stock-based compensation through March 31 was \$2,889 for 2007 and \$2,214 for 2006. As of March 31, 2007, there was \$91,681 of total estimated unrecognized compensation cost related to nonvested stock-based compensation arrangements under our equity compensation and stock purchase plans. The Company expects to recognize this cost over a weighted average remaining period of 1.8 years.

During the three months ended March 31, 2007 and 2006, the Company received \$7,334 and \$18,856, respectively in cash proceeds from stock option exercises and \$6,307 and \$19,515, respectively, in actual tax benefits upon the exercise of stock awards.

4. Long-term debt

Long-term debt was comprised of the following:

	March 31,	December 31,
	2007	2006
Term loan A	\$ 279,250	\$ 279,250
Term loan B	1,705,875	2,105,875
Senior and senior subordinated notes	1,750,000	1,350,000
Capital lease obligations	6,581	6,929
Acquisition obligations and other notes payable	8,780	9,197
Premium on the 6 ⁵ / ₈ % Senior Notes	5,020	
	3,755,506	3,751,251
Less current portion	(34,133)	(20,871)
	\$ 3,721,373	\$ 3,730,380

Table of Contents**DAVITA INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)****(dollars in thousands, except per share data)**

Scheduled maturities of long-term debt at March 31, 2007 were as follows:

2007	\$ 19,863
2008	55,761
2009	63,263
2010	88,068
2011	66,106
2012	1,706,479
Thereafter	1,750,946

On February 23, 2007, the Company issued \$400,000 of 6⁵/₈% senior notes due 2013 in a private offering, realizing \$405,080 in proceeds, which included a \$5,080 premium, and incurred \$2,355 in related deferred financing costs. These senior notes are part of the same series of debt securities as the \$500,000 aggregate principal amount of 6⁵/₈% senior notes that were issued in March 2005. The effective interest rate for the \$400,000 of 6⁵/₈% senior notes is 6.45%. The senior notes are guaranteed by substantially all of the Company's direct and indirect wholly-owned subsidiaries and require semi-annual interest payments beginning March 15, 2007. The senior notes may be redeemed in whole or part at any time on or after March 15, 2009, at certain specified prices. In connection with the issuance of the \$400,000 6⁵/₈% senior notes, the Company also entered into a registration rights agreement that imposes additional interest if the Company does not consummate an effective exchange offer by September 21, 2007. The Company used \$400,000 of these proceeds to pay down its term loan B and also wrote-off \$4,188 of term loan B deferred financing costs, which is included in debt expense.

The Company's senior and senior subordinated notes, as of March 31, 2007, consisted of \$900,000 of 6⁵/₈% senior notes due 2013 and \$850,000 of 7¹/₄% senior subordinated notes due 2015.

On February 23, 2007, the Company amended and restated its existing Senior Secured Credit Facilities to, among other things, reduce the interest rate margin on its term loan B by 0.50%, and to amend certain financial covenants. The new term loan B bears interest at LIBOR plus 1.50%, for an overall effective rate of 5.73%, including the impact of the Company's swap agreements as of March 31, 2007. If the Company refinances the term loan B prior to February 23, 2008, the Company will be subject to a prepayment penalty of 1.0%, otherwise the payment terms remain the same. Other terms that were changed included the amount by which the Company can elect to increase the revolving and term loan commitments from \$500,000 to \$750,000 and certain limitations on the purchases, redemption or acquisitions of capital stock, the payment of dividends and distribution in cash, and growth capital expenditures, including acquisition expenditures, will be eliminated if the Company's leverage ratio is less than 3.5:1. The Company incurred deferred financing costs of \$1,693 and expensed \$248 of other costs in connection with this transaction, which are included in debt expense.

On February 27, 2007, the Company's interest rate margin on its term loan A was reduced by 0.25% as a result of achieving certain financial ratios as defined in the Senior Secured Credit Facilities. The term loan A currently bears interest at LIBOR plus 1.50%, for an overall effective rate of 6.82% as of March 31, 2007. The margin is subject to adjustment depending upon changes in certain financial ratios of the Company and can range from 1.50% to 2.25% for the term loan A, as well as for the revolving credit facility.

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

On April 25, 2007, the Company made a principal prepayment of \$50,000 on its term loan A. Therefore, the Company's scheduled mandatory principal payments on the term loan A are due as follows: \$14,875 in 2008, \$61,250 in 2009, \$87,500 in 2010, and \$65,625 in 2011.

As of March 31, 2007, the Company maintained a total of nine interest rate swap agreements, with amortizing notional amounts totaling \$1,265,000. These agreements had the economic effect of modifying the LIBOR-based variable interest rate on the Company's debt to fixed rates ranging from 3.08% to 4.27%, resulting in a weighted average effective interest rate of 5.38% on the hedged portion of the Company's Senior Secured Credit Facilities, including the term loan B margin of 1.50%. The swap agreements expire in 2008 and 2010 and require quarterly interest payments. During the first three months of 2007, the Company accrued net benefits of \$4,172 from these swaps which is included in debt expense. As of March 31, 2007, the total fair value of these swaps was an asset of \$23,205 and is principally included in other long-term assets.

Total comprehensive income for the three months ended March 31, 2007 was \$77,352, including reductions to other comprehensive income for valuation losses and reclassification of gains on swaps of \$3,476, net of tax, and increases in other comprehensive income for unrealized gains on investments of \$4,246 net of tax.

Total comprehensive income for the three months ended March 31, 2006 was \$63,667, including other comprehensive income valuation gains on swaps of \$6,198, net of tax.

As of March 31, 2007, the interest rates were economically fixed on approximately 64% of the Company's variable rate debt and approximately 81% of its total debt.

As a result of the swap agreements, the overall effective weighted average interest rate on the Senior Secured Credit Facilities was 5.92%, based upon the current margins in effect of 1.50%, as of March 31, 2007.

The Company's overall average effective interest rate excluding amortization of deferred financing costs during the first quarter of 2007 was 6.64% and as of March 31, 2007 was 6.40%.

The Company has undrawn revolving credit facilities totaling \$250,000 of which approximately \$50,000 was committed for outstanding letters of credit. The Company also has undrawn revolving credit facilities totaling \$3,600 associated with several of its joint ventures.

5. Contingencies

The majority of the Company's revenues are from government programs and may be subject to adjustment as a result of: (1) examination by government agencies or contractors, for which the resolution of any matters raised may take extended periods of time to finalize; (2) differing interpretations of government regulations by different fiscal intermediaries or regulatory authorities; (3) differing opinions regarding a patient's medical diagnosis or the medical necessity of services provided; and (4) retroactive applications or interpretations of governmental requirements. In addition, the Company's revenues from commercial payors may be subject to adjustment as a result of potential claims for refunds from commercial payors, as a result of government actions or as a result of other claims by commercial payors.

United States Attorney inquiries

On March 4, 2005, the Company received a subpoena from the United States Attorney's Office, or U.S. Attorney's Office, for the Eastern District of Missouri in St. Louis. The subpoena requires production of a wide

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

range of documents relating to our operations, including documents related to, among other things, pharmaceutical and other services provided to patients, relationships with pharmaceutical companies, and financial relationships with physicians and joint ventures. The subpoena covers the period from December 1, 1996 through the present. In October 2005, the Company received a follow-up request for additional documents related to specific medical director and joint venture arrangements. In February 2006, the Company received an additional subpoena for documents, including certain patient records relating to the administration and billing of Epogen (EPO). The Company is producing documents and providing information to the government. The Company is also cooperating, and intends to continue to cooperate, with the government's investigation, including by participating in discussions and meetings with the government. The subpoenas have been issued in connection with a joint civil and criminal investigation. It is possible that criminal proceedings may be initiated against the Company in connection with this inquiry. Any negative findings could result in substantial financial penalties against the Company, exclusion from future participation in the Medicare and Medicaid programs and criminal penalties. To the Company's knowledge, no proceedings have been initiated against the Company at this time. Although the Company cannot predict whether or when proceedings might be initiated or when these matters may be resolved, it is not unusual for investigations such as this to continue for a considerable period of time. Responding to the subpoenas will continue to require management's attention and significant legal expense.

On October 25, 2004, the Company received a subpoena from the U.S. Attorney's Office for the Eastern District of New York in Brooklyn. The subpoena covers the period from 1996 to present and requires the production of a wide range of documents relating to the Company's operations, including DaVita Laboratory Services. The subpoena also includes specific requests for documents relating to testing for parathyroid hormone levels (PTH), and to products relating to vitamin D therapies. The subpoena has been issued in connection with a joint civil and criminal investigation. It is possible that criminal proceedings may be initiated against the Company in connection with this inquiry. Any negative findings could result in substantial financial penalties against the Company and DVA Renal Healthcare, exclusion from future participation in the Medicare and Medicaid programs and criminal penalties. Other participants in the dialysis industry received a similar subpoena, including Fresenius Medical Group, Renal Care Group and DVA Renal Healthcare, which was acquired by the Company in October of 2005. To the Company's knowledge, no proceedings have been initiated against the Company or DVA Renal Healthcare at this time. Although the Company cannot predict whether or when proceedings might be initiated or when these matters may be resolved, it is not unusual for investigations such as these to continue for a considerable period of time. Responding to the subpoena may continue to require management's attention and significant legal expense.

In February 2001, the Civil Division of the U.S. Attorney's Office for the Eastern District of Pennsylvania in Philadelphia contacted the Company and requested its cooperation in a review of some of its historical practices, including billing and other operating procedures and the Company's financial relationships with physicians. The Company cooperated in this review and provided the requested records to the U.S. Attorney's Office. In May 2002, the Company received a subpoena from the U.S. Attorney's Office and the Philadelphia Office of the Office of Inspector General of the Department of Health and Human Services (OIG). The subpoena required an update to the information the Company provided in its response to the February 2001 request, and also sought a wide range of documents relating to pharmaceutical and other ancillary services provided to patients, including laboratory and other diagnostic testing services, as well as documents relating to the Company's financial relationships with physicians and pharmaceutical companies. The subpoena covered the period from May 1996 to May 2002. The Company provided the documents requested and cooperated with the United States Attorney's Office and the OIG in its investigation. In January 2007, the U.S. Attorney's Office for the Eastern District of Pennsylvania in Philadelphia informed the Company that it decided to close its

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

investigation of DaVita. No charges were made against the Company, no fines were assessed and no mandatory policy changes were required in connection with this investigation.

In February 2007, the Company received a request for information from the Office of Inspector General, U.S. Department of Health and Human Services for records relating to EPO claims submitted to Medicare. The claims relate to services provided from 2002 to 2004 by a number of our centers. The request was sent from the OIG's office in Houston, Texas. The Company has been in contact with the U.S. Attorney's Office for the Eastern District of Texas, which has stated that this is a civil inquiry related to EPO claims. The Company is cooperating with the inquiry and is producing the requested records. There appears to be substantial overlap between this issue, and the ongoing review of EPO utilization and claims by the U.S. Attorney's Office for the Eastern District of Missouri in St. Louis. EPO utilization was also one of the subjects of the multi-year investigation by the U.S. Attorney's Office for the Eastern District of Pennsylvania, which was recently closed as described herein. To the best of the Company's knowledge, the government has not initiated any proceeding against it in connection with this request although the Company cannot predict whether it will receive further inquiries or whether or when a proceeding might be initiated.

Other

The Company has received several notices of claims from commercial payors and other third parties related to historical billing practices and claims against DVA Renal Healthcare related to historical DVA Renal Healthcare billing practices and other matters covered by their settlement agreement with the Department of Justice. At least one commercial payor has filed an arbitration demand against the Company, as described below, and additional commercial payors have threatened litigation. The Company intends to defend against these claims vigorously; however, the Company may not be successful and these claims may lead to litigation and any such litigation may be resolved unfavorably. Although the ultimate outcome of these claims cannot be predicted at this time, an adverse result in excess of the Company's established reserves, with respect to one or more of these claims could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company has received several informal inquiries from representatives of the New York Attorney General's Medicaid Fraud Control Unit (MFCU) regarding certain aspects of the EPO and other billing practices taking place at facilities managed by the Company in New York. The Company is cooperating with the MFCU's informal inquiries and has provided documents and information to the MFCU. To the best of the Company's knowledge, no proceedings have been initiated against the Company and the MFCU has not indicated an intention to do so, although the Company cannot predict whether it will receive further inquiries or whether or when proceedings might be initiated.

In June 2004, DVA Renal Healthcare was served with a complaint filed in the Superior Court of California by one of its former employees who worked for its California acute services program. The complaint, which is styled as a class action, alleges, among other things, that DVA Renal Healthcare failed to provide overtime wages, defined rest periods and meal periods, or compensation in lieu of such provisions and failed to comply with certain other California labor code requirements. The Company is evaluating the claims and intends to vigorously defend itself in the matter. The Company also intends to vigorously oppose the certification of this matter as a class action. Although the ultimate outcome of these claims cannot be predicted, the Company does not expect that an unfavorable result, if any, would have a material adverse effect on the Company's business, financial condition, liquidity or results of operations.

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

On August 8, 2005, Blue Cross/Blue Shield of Louisiana filed a complaint in the United States District Court for the Western District of Louisiana against Gambro AB, DVA Renal Healthcare and related entities. The plaintiff sought to bring its claims as a class action on behalf of itself and all entities that paid any of the defendants for health care goods and services from on or about January 1991 through at least December 2004. The complaint alleged, among other things, damages resulting from facts and circumstances underlying DVA Renal Healthcare's December 2004 settlement agreement with the Department of Justice and certain agencies of the United States Government. In March 2006, the case was dismissed and the plaintiff was compelled to seek arbitration to resolve the matter. In November 2006, the plaintiff filed a demand for class arbitration against the Company and DVA Renal Healthcare. At this time, the Company cannot estimate the potential range of damages, if any. The Company is investigating these claims and continues to vigorously defend itself in the matter.

In addition to the foregoing, the Company is subject to claims and suits in the ordinary course of business, including from time to time, contractual disputes and professional and general liability claims. The Company believes that the ultimate resolution of any such pending proceedings, whether the underlying claims are covered by insurance or not, will not have a material adverse effect on its financial condition, results of operations or cash flows.

6. Other commitments

The Company has obligations to purchase the third-party interests in several of its joint ventures. These obligations are in the form of put provisions in joint venture agreements, and are exercisable at the third-party owners' discretion. If these put provisions are exercised, the Company would be required to purchase the third-party owners' interests at either the appraised fair market value or a predetermined multiple of cash flow or earnings, which approximates fair value. As of March 31, 2007, the Company's potential obligations under these put provisions totaled approximately \$201,000 of which approximately \$100,000 was exercisable within one year. Additionally, the Company has certain other potential commitments to provide operating capital to several minority-owned centers and to third-party centers that the Company operates under administrative service agreements of approximately \$13,000.

The Company is obligated under mandatorily redeemable instruments in connection with certain consolidated joint ventures. Future distributions may be required for the minority partners' interests in limited-life entities which dissolve after terms of ten to fifty years. As of March 31, 2007, such distributions would be valued below the related minority interests balances in the consolidated balance sheet.

7. Investments

In accordance with SFAS No. 115 and based on the Company's intentions and strategy involving investments, the Company classifies certain debt securities as held-to-maturity and records them at amortized cost. Equity securities that have readily determinable fair values and debt securities classified as available for sale are recorded at fair value.

Table of Contents**DAVITA INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)****(dollars in thousands, except per share data)**

The Company's investments consist of the following:

	March 31,			December 31,		
	2007			2006		
	Held to	Available	Total	Held to	Available	Total
Certificates of Deposit, due less than 1 year	\$ 1,515	\$	\$ 1,515	\$ 1,500	\$	\$ 1,500
Investments in mutual funds		11,438	11,438		16,408	16,408
NxStage, Inc. common stock		26,640	26,640			
	\$ 1,515	\$ 38,078	\$ 39,593	\$ 1,500	\$ 16,408	\$ 17,908
Short-term investments	\$ 1,515	\$ 4,300	\$ 5,815	\$ 1,500	\$ 3,234	\$ 4,734
Long-term investments		33,778	33,778		13,174	13,174
	\$ 1,515	\$ 38,078	\$ 39,593	\$ 1,500	\$ 16,408	\$ 17,908

The cost of the certificates of deposit and the investments in mutual funds approximates fair value. The cost of the Company's investment in NxStage, Inc. common stock was \$20,000, see description below. During the three months ended March 31, 2007, the Company recorded \$4,246 of unrealized gains, net of tax, in other comprehensive income associated with changes in the fair value of these investments. During the first quarter of 2007, the Company sold investments in mutual funds totaling \$6,236, and did not recognize any significant gain or loss on these transactions.

On February 7, 2007, the Company entered into a National Provider Agreement with NxStage, Inc. The agreement provides the Company the ability to purchase NxStage home-based hemodialysis products at a potential discount depending upon the achievement of certain volume targets. The agreement has an initial term of three years, terminating on December 31, 2009, and may be extended in six month increments up to two additional years if certain volume targets are met. As a part of the agreement, the Company purchased outright all of its NxStage System One equipment currently in use for \$5,100, and will purchase a majority of its future home-based hemodialysis equipment and supplies from NxStage. In connection with the provider agreement, the Company purchased 2 million shares of NxStage common stock in a private placement offering for \$20,000, representing an ownership position of approximately 7% of NxStage. The Company also entered into a Registration Rights Agreement under which NxStage has agreed to register the shares.

8. Income Taxes

On January 1, 2007, the Company adopted the provisions of Financial Accounting Standards Board Interpretation 48 (FIN 48) *Accounting for Income Tax Uncertainties*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS Statement No. 109 *Accounting for Income Taxes*. The Interpretation prescribes a recognition threshold of more-likely-than-not and a measurement attribute on all tax positions taken or expected to be taken in a tax return in order to be recognized in the financial statements. In making this assessment, a company must determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based solely on the technical merits of the position and must assume that the

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tax position will be examined by appropriate taxing authority that would have full knowledge of all relevant information. Once the recognition threshold is met, the tax position is then measured to determine the actual amount of benefit to recognize in the financial statements. In addition, the recognition threshold of more-likely-than-not must

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

continue to be met in each reporting period to support continued recognition of the tax benefit. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the financial reporting period in which that threshold is no longer met.

As a result of implementing FIN 48, the Company recognized an increase of \$22,900 to the beginning balance of its current and long-term deferred tax assets, offset by increases in its current and long-term income taxes payable of \$19,000. This net recognized tax benefit of \$3,900 was recorded as an increase to the beginning balance of retained earnings on January 1, 2007. The Company also recorded a decrease of \$4,950 to the beginning balance of current and long-term deferred tax liabilities, and a corresponding decrease to Goodwill as a result of recognizing tax benefits associated with our acquisition of DVA Renal Healthcare.

As of January 1, 2007, the Company's total liability for unrecognized tax benefits relating to tax positions that do not meet the more-likely-than-not threshold is \$27,900, of which it is reasonably possible that a decrease of \$21,000 will be recognized within the next 12 months, primarily related to the filing of a tax accounting method change request for recently acquired entities. This change will have no impact on the Company's effective tax rate. As of January 1, 2007 unrecognized tax benefits totaling \$6,500 would affect the Company's effective tax rate if recognized.

The Company recognizes accrued interest and penalties related to unrecognized tax benefits in its income tax expense. As of January 1, 2007, the Company has accrued approximately \$1,300 in interest and penalties related to unrecognized tax benefits.

The Company and its subsidiaries file U.S. federal income tax returns and various state returns. The Company is no longer subject to U.S. federal state and local examinations by tax authorities for years before 2001. The Internal Revenue Service (IRS) is currently examining the Company's U.S. federal income tax returns for 2003 through 2004. It is anticipated that this examination will be completed during the second quarter of 2007. The Company does not anticipate any material impact to its consolidated financial statements as a result of this examination.

9. Condensed consolidating financial statements

The following information is presented in accordance with Rule 3-10 of Regulation S-X. The operating and investing activities of the separate legal entities included in the consolidated financial statements are fully interdependent and integrated. Revenues and operating expenses of the separate legal entities include intercompany charges for management and other services. The senior notes and the senior subordinated notes were issued by the Company and are guaranteed by substantially all of the Company's direct and indirect wholly-owned subsidiaries. Each of the guarantor subsidiaries has guaranteed the notes on a joint and several, full and unconditional basis. Non-wholly-owned subsidiaries, joint venture partnerships and other third parties are not guarantors of these obligations.

Table of Contents**DAVITA INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)****(dollars in thousands, except per share data)****Condensed Consolidating Statements of Income**

		Guarantor	Non-Guarantor	Consolidating	Consolidated
For the three months ended March 31, 2007	DaVita Inc.	Subsidiaries	Subsidiaries	Adjustments	Total
Net operating revenues	\$ 91,348	\$ 1,109,229	\$ 174,916	\$ (97,327)	\$ 1,278,166
Operating expenses	46,981	982,758	141,819	(97,327)	1,074,231
Minority interests				10,618	10,618
Operating income	44,367	126,471	33,097	(10,618)	193,317
Debt (expense) income	(69,499)	(68,996)	(424)	70,049	(68,870)
Other income	72,856		388	(70,049)	3,195
Income tax expense	18,612	32,448			51,060
Discontinued operations, net of tax					
Equity earnings in subsidiaries	47,470	22,443		(69,913)	
Net income	\$ 76,582	\$ 47,470	\$ 33,061	\$ (80,531)	\$ 76,582

		Guarantor	Non-Guarantor	Consolidating	Consolidated
For the three months ended March 31, 2006	DaVita Inc.	Subsidiaries	Subsidiaries	Adjustments	Total
Net operating revenues	\$ 80,280	\$ 1,021,729	\$ 147,238	\$ (86,059)	\$ 1,163,188
Operating expenses	45,540	914,388	120,043	(86,059)	993,912
Minority interests				7,201	7,201
Operating income	34,740	107,341	27,195	(7,201)	162,075
Debt (expense) income	(70,954)	(71,483)	(609)	72,587	(70,459)
Other income	76,461			(72,587)	3,874
Income tax expense	15,696	21,968	46		37,710
Discontinued operations, net of tax		(311)			(311)
Equity earnings in subsidiaries	32,918	19,339		(52,257)	
Net income	\$ 57,469	\$ 32,918	\$ 26,540	\$ (59,458)	\$ 57,469

Table of Contents**DAVITA INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)****(dollars in thousands, except per share data)****Condensed Consolidating Balance Sheets**

	DaVita	Guarantor	Non-Guarantor	Consolidating	Consolidated
As of March 31, 2007	Inc.	Subsidiaries	Subsidiaries	Adjustments	Total
Cash and cash equivalents	\$ 341,354	\$	\$ 15,030		\$ 356,384
Accounts receivable, net		792,058	114,452		906,510
Other current assets	9,710	463,232	12,196		485,138
Total current assets	351,064	1,255,290	141,678		1,748,032
Property and equipment, net	32,400	687,522	134,875		854,797
Amortizable intangibles, net	56,678	136,350	1,713		194,741
Investments in subsidiaries	3,989,886	420,657		\$ (4,410,543)	
Receivables from subsidiaries	789,797		71,023	(860,820)	
Other long-term assets and investments	53,038	1,818	22,480		77,336
Goodwill		3,439,457	223,634		3,663,091
Total assets	\$ 5,272,863	\$ 5,941,094	\$ 595,403	\$ (5,271,363)	\$ 6,537,997
Current liabilities	\$ 167,561	\$ 840,184	\$ 35,301		\$ 1,043,046
Payables to parent and subsidiaries		860,820		\$ (860,820)	
Long-term debt and other long-term liabilities	3,751,159	250,204	11,949		4,013,312
Minority interests				127,496	127,496
Shareholders' equity	1,354,143	3,989,886	548,153	(4,538,039)	1,354,143
Total liabilities and shareholders' equity	\$ 5,272,863	\$ 5,941,094	\$ 595,403	\$ (5,271,363)	\$ 6,537,997
As of December 31, 2006					
Cash and cash equivalents	\$ 299,430	\$	\$ 10,722		\$ 310,202
Accounts receivable, net		809,028	123,357		932,385
Other current assets	6,660	448,421	11,828		466,909
Total current assets	306,090	1,257,449	145,957		1,709,496
Property and equipment, net	30,130	689,039	130,797		849,966
Amortizable intangibles, net	59,371	142,394	1,956		203,721
Investments in subsidiaries	3,904,797	388,919		\$ (4,293,716)	
Receivables from subsidiaries	812,201		30,928	(843,129)	
Other long-term assets and investments	25,190	14,650	20,940		60,780
Goodwill		3,444,224	223,629		3,667,853
Total assets	\$ 5,137,779	\$ 5,936,675	\$ 554,207	\$ (5,136,845)	\$ 6,491,816
Current liabilities	\$ 166,440	\$ 915,554	\$ 30,178		\$ 1,112,172
Payables to parent and subsidiaries		843,129		\$ (843,129)	
Long-term debt and other long-term liabilities	3,725,415	273,195	12,751		4,011,361

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Minority interests				122,359	122,359
Shareholders' equity	1,245,924	3,904,797	511,278	(4,416,075)	1,245,924
Total liabilities and shareholders' equity	\$ 5,137,779	\$ 5,936,675	\$ 554,207	\$ (5,136,845)	\$ 6,491,816

Table of Contents**DAVITA INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)****(unaudited)****(dollars in thousands, except per share data)****Condensed Consolidating Statements of Cash Flows**

For the three months ended March 31, 2007	DaVita Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Cash flows from operating activities					
Net income	\$ 76,582	\$ 47,470	\$ 33,061	\$ (80,531)	\$ 76,582
Changes in operating and intercompany assets and liabilities and non cash items included in net income	(34,743)	(2,008)	(32,331)	80,531	11,449