WATSON PHARMACEUTICALS INC
Form 10-Q
November 05, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2010

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 001-13305

WATSON PHARMACEUTICALS, INC.
(Exact name of registrant as specified in its charter)

Nevada	**95-3872914**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

311 Bonnie Circle
Corona, CA 92880-2882
(Address of principal executive offices, including zip code)
(951) 493-5300
(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 þ No o

Indicate by check mark whether the Registrant (1) 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 þ 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.

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a 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 þ

The number of shares outstanding of the Registrant s only class of common stock as of November 1, 2010 was approximately 125,309,000.

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WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited; in millions)

	September 30, 2010	December 31, 2009 Revised
ASSETS		
Current assets:		
Cash and cash equivalents	$ 255.6	$ 201.4
Marketable securities	10.3	13.6
Accounts receivable, net	523.1	517.4
Inventories, net	673.1	692.3
Prepaid expenses and other current assets	159.9	213.9
Deferred tax assets	142.2	130.9
Total current assets	1,764.2	1,769.5
Property and equipment, net	648.9	694.2
Investments and other assets	47.9	114.5
Deferred tax assets	168.3	110.8
Product rights and other intangibles, net	1,690.3	1,713.5
Goodwill	1,528.1	1,501.0
Total assets	$ 5,847.7	$ 5,903.5
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 625.0	$ 614.3
Income taxes payable	45.1	78.4
Short-term debt and current portion of long-term debt	35.0	307.6
Deferred revenue	20.9	16.3
Deferred tax liabilities	27.7	31.3
Total current liabilities	753.7	1,047.9
Long-term debt	1,162.1	1,150.2
Deferred revenue	23.0	31.9
Other long-term liabilities	175.9	118.7
Other taxes payable	59.4	76.0
Deferred tax liabilities	454.0	455.7
Total liabilities	2,628.1	2,880.4
Commitments and contingencies		
Equity:		
Common stock	0.4	0.4
Additional paid-in capital	1,739.4	1,686.9
Retained earnings	1,806.2	1,640.1
Accumulated other comprehensive (loss) income	(16.1)	1.9

Treasury stock, at cost		(311.9)		(306.2)
Total stockholders equity		3,218.0		3,023.1
Noncontrolling interest		1.6		
Total equity		3,219.6		3,023.1
Total liabilities and equity	$	5,847.7	$	5,903.5

See accompanying Notes to Condensed Consolidated Financial Statements.

WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited; in millions, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Net revenues	$ 882.4	$ 662.1	$ 2,614.2	$ 2,007.3
Operating expenses:				
Cost of sales (excludes amortization, presented below)	484.6	353.7	1,487.3	1,135.5
Research and development	75.8	51.9	197.1	136.8
Selling and marketing	78.1	60.0	236.4	191.9
General and administrative	163.5	60.1	313.8	191.1
Amortization	45.9	22.2	128.0	66.1
Loss on asset sales	0.1	3.5	1.2	2.2
Total operating expenses	848.0	551.4	2,363.8	1,723.6
Operating income	34.4	110.7	250.4	283.7
Non-operating (expense) income:				
Loss on early extinguishment of debt		(2.0)		(2.0)
Interest income	0.3	1.0	1.0	4.3
Interest expense	(21.4)	(9.0)	(61.7)	(18.3)
Other income	0.2	1.6	28.8	5.2
Total other expense, net	(20.9)	(8.4)	(31.9)	(10.8)
Income before income taxes	13.5	102.3	218.5	272.9
Provision (benefit) for income taxes	(12.2)	39.3	52.4	107.8
Net income attributable to common shareholders	$ 25.7	$ 63.0	$ 166.1	$ 165.1
Earnings per share:				
Basic	$ 0.21	$ 0.61	$ 1.36	$ 1.60
Diluted	$ 0.21	$ 0.55	$ 1.34	$ 1.45
Weighted average shares outstanding:				
Basic	122.6	103.8	122.2	103.4
Diluted	124.3	117.1	123.9	118.1

See accompanying Notes to Condensed Consolidated Financial Statements.

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WATSON PHARMACEUTICALS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited; in millions)

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 166.1	$ 165.1
Reconciliation to net cash provided by operating activities:		
Depreciation	76.4	71.5
Amortization	128.0	66.1
Deferred income tax (benefit) provision	(75.7)	8.4
Provision for inventory reserve	30.7	36.0
Restricted stock and stock option compensation	17.4	14.4
Earnings on equity method investments	(3.2)	(6.2)
(Gain) loss on securities	(26.5)	1.1
Loss on early extinguishment of debt		2.0
Accretion of discount on preferred stock and contingent consideration obligations	21.5	
Loss on asset sales	0.5	2.2
Other	0.9	1.0
Changes in assets and liabilities:		
Accounts receivable, net	(12.2)	(72.1)
Inventories	(16.3)	(68.6)
Prepaid expenses and other current assets	28.1	(10.1)
Accounts payable and accrued expenses	11.7	17.7
Deferred revenue	(4.3)	8.9
Income taxes payable	(25.2)	(6.6)
Other assets	4.7	4.8
Total adjustments	156.5	70.5
Net cash provided by operating activities	322.6	235.6
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property and equipment	(33.6)	(43.2)
Acquisition of product rights	(7.4)	(16.3)
Acquisition of business, net of cash acquired	(67.4)	
Proceeds from sale of fixed assets	2.3	3.0
Proceeds from sale of cost/equity investments	94.7	
Proceeds from sale of marketable securities	9.5	5.9
Additions to marketable securities	(5.5)	(4.4)
Additions to long-term investments	(13.7)	
Other investing activities, net	1.0	
Net cash used in investing activities	(20.1)	(55.0)
CASH FLOWS FROM FINANCING ACTIVITIES:		

Principal payments on debt and other long-term liabilities	(274.6)	(726.6)
Proceeds from issuance of debt and other long-term liabilities		833.0
Repurchase of common stock	(5.7)	(3.2)
Proceeds from stock plans	32.5	21.5
Net cash (used in) provided by financing activities	(247.8)	124.7
Effect of currency exchange rate changes on cash and cash equivalents	(0.5)	
Net increase in cash and cash equivalents	54.2	305.3
Cash and cash equivalents at beginning of period	201.4	507.6
Cash and cash equivalents at end of period	$ 255.6	$ 812.9

See accompanying Notes to Condensed Consolidated Financial Statements.

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WATSON PHARMACEUTICALS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 GENERAL

Watson Pharmaceuticals, Inc. (Watson or the Company) is primarily engaged in the development, manufacturing, marketing, sale and distribution of brand and off-patent (generic) pharmaceutical products. Watson was incorporated in 1985 and began operations as a manufacturer and marketer of off-patent pharmaceuticals. Through internal product development and synergistic acquisitions of products and businesses, the Company has grown into a diversified specialty pharmaceutical company. Watson operates manufacturing, distribution, research and development (R&D) and administrative facilities in the United States of America (U.S.) and India and, beginning in 2009, has added operations in key international markets including Western Europe, Canada, Australasia, Asia, South America and South Africa.

The accompanying condensed consolidated financial statements should be read in conjunction with the Company s Annual Report on Form 10-K for the year ended December 31, 2009. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with generally accepted accounting principles (GAAP) have been condensed or omitted from the accompanying condensed consolidated financial statements. The accompanying year end condensed consolidated balance sheet was derived from the audited financial statements and includes revisions to certain December 31, 2009 balances reflecting the completion of the Company s purchase price allocation (refer to NOTE 3 ACQUISITIONS and DIVESTITURES.) The accompanying interim financial statements are unaudited, but reflect all adjustments which are, in the opinion of management, necessary to present fairly Watson s consolidated financial position, results of operations and cash flows for the periods presented. Unless otherwise noted, all such adjustments are of a normal, recurring nature. The Company s results of operations and cash flows for the interim periods are not necessarily indicative of the results of operations and cash flows that it may achieve in future periods.

Comprehensive Income

Comprehensive income includes all changes in equity during a period except those that resulted from investments by or distributions to the Company s stockholders. Other comprehensive income (loss) refers to revenues, expenses, gains and losses that, under GAAP, are included in comprehensive income, but excluded from net income as these amounts are recorded directly as an adjustment to stockholders equity. Watson s other comprehensive income (loss) is composed of unrealized (losses) gains on its holdings of publicly traded equity securities, net of realized gains or losses included in net income and foreign currency translation adjustments. The components of comprehensive income, including attributable income taxes, where applicable, consisted of the following (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Net income	$ 25.7	$ 63.0	$ 166.1	$ 165.1
Other comprehensive income (loss):				
Translation gains (losses)	43.7	(0.6)	(16.9)	1.4
Unrealized gain (loss) on securities, net of tax	0.2	0.1	(0.5)	0.2
Reclassification of (gains) losses included in net income, net of tax			(0.6)	1.4
Total other comprehensive income (loss)	43.9	(0.5)	(18.0)	3.0
Total comprehensive income	$ 69.6	$ 62.5	$ 148.1	$ 168.1

Preferred and Common Stock

As of September 30, 2010 and December 31, 2009 there were 2.5 million shares of no par value per share preferred stock authorized. The Board has the authority to fix the rights, preferences, privileges and restrictions, including but not limited to, dividend rates, conversion and voting rights, terms and prices of redemptions and liquidation preferences without vote or action by the stockholders. On December 2, 2009 the Company issued 200,000 shares of Mandatorily Redeemable Preferred Stock. The Mandatorily Redeemable Preferred Stock is redeemable in cash on December 2, 2012, and is accordingly included within long-term debt in the consolidated balance sheet at September 30, 2010 and December 31, 2009. See Note 7 DEBT for additional discussion. As of September 30, 2010 and December 31, 2009, there were 500.0 million shares of $0.0033 par value per share common stock authorized, with 134.9 million and 133.0 million shares issued and 125.1 million and 123.4 million outstanding, respectively. Of the issued shares, 9.7 million shares and 9.6 million shares were held as treasury shares as of September 30, 2010 and December 31, 2009, respectively.

Provisions for Sales Returns and Allowances

As is customary in the pharmaceutical industry, the Company s gross product sales are subject to a variety of deductions in arriving at reported net product sales. When the Company recognizes revenue from the sale of its products, an estimate of sales returns and allowances (SRA) is recorded which reduces product sales. Accounts receivable and/or accrued liabilities are also reduced and/or increased by the SRA amount. These adjustments include estimates for chargebacks, rebates, cash discounts and returns and other allowances. These provisions are estimated based on historical payment experience, historical relationship to revenues, estimated customer inventory levels and current contract sales terms with direct and indirect customers. The estimation process used to determine our SRA provision has been applied on a consistent basis and no material adjustments have been necessary to increase or decrease our reserves for SRA as a result of a significant change in underlying estimates. The Company uses a variety of methods to assess the adequacy of our SRA reserves to ensure that our condensed consolidated financial statements are fairly stated. This includes periodic reviews of customer inventory data, customer contract programs and product pricing trends to analyze and validate the SRA reserves.

The provision for chargebacks is our most significant sales allowance. A chargeback represents an amount payable in the future to a wholesaler for the difference between the invoice price paid to the Company by our wholesale customer for a particular product and the negotiated contract price that the wholesaler s customer pays for that product. The Company s chargeback provision and related reserve vary with changes in product mix, changes in customer pricing and changes to estimated wholesaler inventories. The provision for chargebacks also takes into account an estimate of the expected wholesaler sell-through levels to indirect customers at contract prices. The Company validates the chargeback accrual quarterly through a review of the inventory reports obtained from our largest wholesale customers. This customer inventory information is used to verify the estimated liability for future chargeback claims based on historical chargeback and contract rates. These large wholesalers represent 85% 90% of the Company s chargeback payments. The Company continually monitors current pricing trends and wholesaler inventory levels to ensure the liability for future chargebacks is fairly stated.

A number of factors impact the level of SRA as a percentage of gross accounts receivable. These factors include sales levels for our Distribution segment which has lower levels of SRA relative to our other segments and sales of our recently acquired Arrow Group (refer to NOTE 3 ACQUISITIONS AND DIVESTITURES) with operations in Western Europe, Canada, Australasia, South America and South Africa, which has lower levels of SRA compared to our U.S. generic business.

Net revenues and accounts receivable balances in the Company s condensed consolidated financial statements are presented net of SRA estimates. Certain SRA balances are included in accounts payable and accrued liabilities. Accounts receivable are presented net of SRA balances of $330.9 million and $332.9 million at September 30, 2010 and December 31, 2009, respectively. Accounts payable and accrued liabilities include $85.4 million and $85.7 million at September 30, 2010 and December 31, 2009, respectively, for certain rebates and other amounts due to indirect customers.

Earnings Per Share (EPS)

Basic EPS is computed by dividing net income by the weighted average common shares outstanding during a period. Diluted EPS is based on the treasury stock method and includes the effect from potential issuance of common stock, such as shares issuable pursuant to the exercise of stock options, assuming the exercise of all in-the-money stock options. Common share equivalents have been excluded where their inclusion would be anti-dilutive. For the three and nine month periods ended September 30, 2009, the Company is required to add the weighted average potential common shares outstanding associated with the conversion of the convertible contingent senior debentures (CODES) to the number of shares outstanding for the calculation of diluted EPS for all periods in which the securities were outstanding. On September 14, 2009 the CODES were redeemed.

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A reconciliation of the numerators and denominators of basic and diluted EPS consisted of the following (in millions, except per share amounts):

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
EPS basic				
Net income	$ 25.7	$ 63.0	$ 166.1	$ 165.1
Basic weighted average common shares outstanding	122.6	103.8	122.2	103.4
EPS basic	$ 0.21	$ 0.61	$ 1.36	$ 1.60
EPS diluted				
Net income	$ 25.7	$ 63.0	$ 166.1	$ 165.1
Add: Interest expense on CODES, net of tax		1.6		5.5
Net income, adjusted	$ 25.7	$ 64.6	$ 166.1	$ 170.6
Basic weighted average common shares outstanding	122.6	103.8	122.2	103.4
Effect of dilutive securities:				
Conversion of CODES		11.9		13.6
Dilutive stock awards	1.7	1.4	1.7	1.1
Diluted weighted average common shares outstanding	124.3	117.1	123.9	118.1
EPS diluted	$ 0.21	$ 0.55	$ 1.34	$ 1.45

Stock awards to purchase 1.0 million and 2.9 million common shares for the three month periods ended September 30, 2010 and 2009, respectively, were outstanding but were not included in the computation of diluted earnings per share because the awards were anti-dilutive. Stock awards to purchase 1.3 million and 3.9 million common shares for the nine month periods ended September 30, 2010 and 2009, respectively, were outstanding but were not included in the computation of diluted earnings per share because the awards were anti-dilutive.

Share-Based Compensation

The Company recognizes compensation expense for all share-based compensation awards made to employees and directors based on estimated fair values. Share-based compensation expense recognized during a period is based on the value of the portion of share-based awards that are expected to vest with employees. Accordingly, the recognition of share-based compensation expense has been reduced for estimated future forfeitures. These estimates will be revised in future periods if actual forfeitures differ from the estimates. Changes in forfeiture estimates impact compensation expense in the period in which the change in estimate occurs.

As of September 30, 2010, the Company had $0.6 million of total unrecognized compensation expense, net of estimated forfeitures, related to stock option awards, which will be recognized over the remaining weighted average period of 1.3 years. As of September 30, 2010, the Company had $33.0 million of total unrecognized compensation expense, net of estimated forfeitures, related to restricted stock awards, which will be recognized over the remaining weighted average period of 1.8 years. During the nine months ended September 30, 2010, the Company issued approximately 1.0 million restricted stock awards with an aggregate intrinsic value of $41.8 million. No stock option awards were issued during the nine months ended September 30, 2010.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued an amendment to the accounting and disclosure requirements for the consolidation of variable interest entities (VIEs). The amendment

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eliminates the quantitative approach previously required for determining the primary beneficiary of a VIE and requires an enterprise to perform a qualitative analysis when determining whether or not to consolidate a VIE. The amendment requires an enterprise to continuously reassess whether it must consolidate a VIE and also requires enhanced disclosures about an enterprise s involvement with a VIE and any significant change in risk exposure due to that involvement, as well as how its involvement with a VIE impacts the enterprise s financial statements. This amendment is effective for fiscal years beginning after November 15, 2009. The adoption of the provisions of the guidance did not have a material impact on the Company s condensed consolidated financial statements.

In October 2009, the FASB issued an amendment to its accounting guidance on revenue arrangements with multiple deliverables, which addresses the unit of accounting for arrangements involving multiple deliverables and how consideration should be allocated to separate units of accounting, when applicable. The amendment requires arrangement considerations be allocated at the inception of the arrangement to all deliverables using the relative selling price method and provides for expanded disclosures related to such arrangements. The amendment is effective for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. Early adoption is allowed. We are currently evaluating the impact of the adoption of this amendment on the Company s condensed consolidated financial statements.

In January 2010, the FASB issued an amendment to the disclosure requirements for fair value measurements. The amendment requires an entity to: (i) disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers, and (ii) present separate information for Level 3 activity pertaining to gross purchases, sales, issuances and settlements. The new disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the Level 3 disclosures, which are effective for fiscal years beginning after December 15, 2010. We will include the required Level 3 disclosures, as necessary, beginning in 2011. No additional disclosures have been required for Level 1 or 2 fair value measurements in the current period.

In March 2010, the FASB ratified accounting guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for research or development transactions. This guidance provides criteria that must be met to recognize consideration that is contingent upon achievement of a substantive milestone in its entirety in the period in which the milestone is achieved. The amendment is effective for milestones achieved in fiscal years beginning on or after June 15, 2010. Early adoption is allowed. We are currently evaluating the impact of the adoption of this amendment on the Company s condensed consolidated financial statements.

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NOTE 2 OTHER INCOME

Other income consisted of the following (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Earnings (loss) on equity method investments	$ (0.1)	$ 1.5	$ 3.2	$ 6.2
Gain (loss) on securities			24.8	(1.1)
Other income	0.3	0.1	0.8	0.1
	$ 0.2	$ 1.6	$ 28.8	$ 5.2