WRIGHT MEDICAL GROUP INC
Form 10-Q
May 02, 2006

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2006

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: 000-32883

WRIGHT MEDICAL GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**13-4088127**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)
5677 Airline Road Arlington, Tennessee	**38002**
(Address of Principal Executive Offices)	(Zip Code)

(901) 867-9971

(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. þ Yes o 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 þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. o Yes þ No

As of April 28, 2006, there were 34,205,123 shares of common stock outstanding.

WRIGHT MEDICAL GROUP, INC.
TABLE OF CONTENTS

		Page Number
PART I FINANCIAL INFORMATION		
Item 1.	Financial Statements.	
	Condensed Consolidated Balance Sheets as of March 31, 2006 and December 31, 2005	1
	Condensed Consolidated Statements of Operations for the three months ended March 31, 2006 and 2005	2
	Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2006 and 2005	3
	Notes to Condensed Consolidated Financial Statements	4
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations.	12
Item 3.	Quantitative and Qualitative Disclosures About Market Risk.	19
Item 4.	Controls and Procedures.	20
PART II OTHER INFORMATION		
Item 1.	Legal Proceedings.	21
Item 1A.	Risk Factors.	
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds.	21
Item 3.	Defaults Upon Senior Securities.	21
Item 4.	Submission of Matters to a Vote of Security Holders.	21
Item 5.	Other Information.	21
Item 6.	Exhibits.	22
SIGNATURES		25

EX-10.15 EMPLOYMENT AGREEMENT 11/22/05 JASON P. HOOD
EX-31.1 SECTION 302 CERTIFICATION OF THE CEO
EX-31.2 SECTION 302 CERTIFICATION OF THE CFO
EX-32 SECTION 906 CERTIFICATION OF THE CEO & CFO

SAFE-HARBOR STATEMENT

This quarterly report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements made in this quarterly report, other than statements of historical fact, are forward-looking statements. Forward-looking statements reflect management s current knowledge, assumptions, beliefs, estimates, and expectations and express management s current views of future performance, results, and trends. We wish to caution readers that actual results might differ materially from those described in the forward-looking statements. Forward-looking statements are subject to a number of risks and uncertainties, including the factors discussed in our filings with the Securities and Exchange Commission (including those described in Item 1A of our annual report on Form 10-K for the year ended December 31, 2005, and elsewhere in this quarterly report), which could cause our actual results to materially differ from those described in the forward-looking statements. Although we believe that the forward-looking statements are accurate, there can be no assurance that any forward-looking statement will prove to be accurate. A forward-looking statement should not be regarded as a representation by us that the results described therein will be achieved. We wish to caution readers not to place undue reliance on any forward-looking statement. The forward-looking statements are made as of the date of this quarterly report, and we assume no obligation to update any forward-looking statement after this date.

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

WRIGHT MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

	March 31, 2006 (unaudited)	December 31, 2005
Assets:		
Current assets:		
Cash and cash equivalents	$ 59,986	$ 51,277
Marketable Securities	24,100	25,000
Accounts receivable, net	64,236	61,729
Inventories	85,908	82,381
Prepaid expenses	4,419	11,025
Deferred income taxes	24,904	24,218
Other current assets	5,471	4,751
Total current assets	269,024	260,381
Property, plant and equipment, net	83,162	81,206
Goodwill	7,994	7,829
Intangible assets, net	11,758	12,724
Deferred income taxes	9,504	8,217
Other assets	1,585	1,453
	$ 383,027	$ 371,810
Liabilities and Stockholders Equity:		
Current liabilities:		
Accounts payable	$ 14,859	$ 13,572
Accrued expenses and other current liabilities	47,920	45,055
Current portion of long-term obligations	5,246	5,628
Total current liabilities	68,025	64,255
Long-term obligations	1,331	1,728
Deferred income taxes	134	151
Other liabilities	13,833	13,668
Total liabilities	83,323	79,802
Commitments and contingencies (Note 9)		
Stockholders equity:		
	342	342

Common stock, voting, $.01 par value, authorized: 100,000,000 shares; issued and outstanding: 34,204,507 shares at March 31, 2006 and 34,175,696 shares at December 31, 2005		
Additional paid-in capital	278,486	274,312
Accumulated other comprehensive income	13,169	11,957
Retained earnings	7,707	5,397
Total stockholders equity	299,704	292,008
	$ 383,027	$ 371,810

The accompanying notes are an integral part of these condensed consolidated financial statements.

1

WRIGHT MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(unaudited)

	Three Months Ended March 31,	
	2006	**2005**
Net sales	$ 86,256	$ 82,601
Cost of sales[1]	23,393	22,788
Gross profit	62,863	59,813
Operating expenses:		
Selling, general and administrative[1]	49,486	41,869
Research and development[1]	7,343	4,897
Amortization of intangible assets	1,146	1,059
Total operating expenses	57,975	47,825
Operating income	4,888	11,988
Interest (income) expense, net	(250)	90
Other expense, net	124	174
Income before income taxes	5,014	11,724
Provision for income taxes	2,705	4,455
Net income	$ 2,309	$ 7,269
Net income per share (Note 7):		
Basic	$ 0.07	$ 0.21
Diluted	$ 0.07	$ 0.21
Weighted-average number of shares outstanding-basic	34,198	33,875
Weighted-average number of shares outstanding-diluted	35,177	35,201

1 These line items include the following amounts of non-cash stock-based expense for the periods

indicated:

	Three Months Ended March 31,	
	2006	2005
Cost of sales	$ 66	$ 11
Selling, general and administrative	2,733	201
Research and development	577	
	$ 3,376	$ 212

The accompanying notes are an integral part of these condensed consolidated financial statements.

2

Table of Contents

WRIGHT MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(unaudited)

	Three Months Ended March 31,	
	2006	**2005**
Operating activities:		
Net income	$ 2,309	$ 7,269
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	4,635	4,414
Stock-based expense	3,376	212
Amortization of intangible assets	1,146	1,059
Deferred income taxes	(1,673)	(1,314)
Other	(126)	298
Changes in assets and liabilities:		
Accounts receivable	(1,992)	(3,210)
Inventories	(2,765)	(3,081)
Marketable securities	900	
Other current assets	5,537	(62)
Accounts payable	1,130	1,867
Accrued expenses and other liabilities	2,118	3,881
Net cash provided by operating activities	14,595	11,333
Investing activities:		
Capital expenditures	(6,463)	(5,863)
Other	500	
Net cash used in investing activities	(5,963)	(5,863)
Financing activities:		
Issuance of common stock	471	209
Payments of bank and other financing	(851)	(334)
Financing under factoring agreements, net	361	(576)
Excess tax benefit from stock-based compensation arrangements	31	
Net cash provided by (used in) financing activities	12	(701)
Effect of exchange rates on cash and cash equivalents	65	(203)
Net increase in cash and cash equivalents	$ 8,709	$ 4,566
Cash and cash equivalents, beginning of period	$ 51,277	$ 83,470
Cash and cash equivalents, end of period	$ 59,986	$ 88,036

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

Basis of Presentation. The unaudited condensed consolidated interim financial statements of Wright Medical Group, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States (U.S.) for interim financial information and the instructions to Quarterly Report on Form 10-Q and Rule 10-01 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to these rules and regulations. Accordingly, these unaudited condensed consolidated interim financial statements should be read in conjunction with the Company s consolidated financial statements and related notes included in the Company s annual report on Form 10-K for the year ended December 31, 2005, as filed with the Securities and Exchange Commission (SEC).

In the opinion of management, these unaudited condensed consolidated interim financial statements reflect all adjustments necessary for a fair presentation of the Company s interim financial results. All such adjustments are of a normal and recurring nature. The results of operations for any interim period are not necessarily indicative of results for the full fiscal year.

The accompanying unaudited condensed consolidated interim financial statements include the accounts of the Company and its wholly-owned domestic and international subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Stock-Based Compensation. Effective January 1, 2006, we adopted the provisions of, and account for stock-based compensation in accordance with, Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share-Based Payment* (FAS 123R), which replaced SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*. Under the fair value recognition provisions of FAS 123R, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period. The Company elected the modified-prospective method of transition, under which prior periods are not revised for comparative purposes.

The Company recorded approximately $3.4 million of stock-based compensation during the three-month period ended March 31, 2006. See Note 6 for further information regarding our stock-based compensation assumptions and expenses, including pro forma disclosures for prior periods as if the Company had applied the fair value recognition provisions of SFAS No. 123 to non-cash stock-based employee compensation expense.

Derivative Instruments. The Company accounts for derivative instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended by SFAS No. 138. Accordingly, all of the Company s derivative instruments are recorded on the balance sheet as either an asset or liability and measured at fair value. The changes in the derivative s fair value are recognized currently in earnings unless specific hedge accounting criteria are met.

The Company employs a derivative program using 30-day foreign currency forward contracts to mitigate the risk of currency fluctuations on its intercompany receivable and payable balances that are denominated in foreign currencies. These forward contracts are expected to offset the transactional gains and losses on the related intercompany balances. These forward contracts are not designated as hedging instruments under SFAS No. 133. Accordingly, the changes in the fair value and the settlement of the contracts are recognized in the period incurred in the accompanying condensed consolidated statement of operations.

For the three month periods ended March 31, 2006 and 2005, the Company recorded approximately $450,000 in net losses and $420,000 in net gains, respectively, on foreign currency contracts, which are included in Other expense, net in the Company s condensed consolidated statement of operations. These gains and losses substantially offset translation losses and gains recorded on the Company s intercompany receivable and payable balances, also included in Other expense, net. At March 31, 2006, and December 31, 2005, the Company did not have any outstanding foreign currency contracts.

Table of Contents

WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

2. Inventories

Inventories consist of the following (in thousands):

	March 31, 2006	December 31, 2005
Raw materials	$ 4,160	$ 4,186
Work-in-process	16,199	14,417
Finished goods	65,549	63,778
	$ 85,908	$ 82,381

3. Property, Plant and Equipment, Net

Property, plant and equipment consists of the following (in thousands):

	March 31, 2006	December 31, 2005
Property, plant and equipment, at cost	$ 153,944	$ 148,252
Less: Accumulated depreciation	(70,782)	(67,046)
	$ 83,162	$ 81,206

4. Long-Term Obligations

Long-term obligations consist of the following (in thousands):

	March 31, 2006	December 31, 2005
Notes payable	$ 3,750	$ 3,750
Capital lease obligations	2,827	3,606
	6,577	7,356
Less: current portion	(5,246)	(5,628)
	$ 1,331	$ 1,728

At March 31, 2006, the Company s senior credit facility consisted of $3.8 million in outstanding term loan borrowings and availability under a revolving loan facility totaling $60 million. At the Company s option, borrowings under the credit facility bear interest either at a rate equal to a fixed base rate plus a spread of .75% to 1.25% or at a rate equal to an adjusted LIBOR plus a spread of 1.75% to 2.25%, depending on the Company s consolidated leverage ratio, with a current annual rate of 6.6%.

5. Goodwill and Intangible Assets

Changes in the carrying amount of goodwill occurring during the three months ended March 31, 2006 are as follows (in thousands):

Goodwill at December 31, 2005	$ 7,829

Foreign currency translation	165
Goodwill at March 31, 2006	$ 7,994

Table of Contents

WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The components of the Company s identifiable intangible assets are as follows (in thousands):

	March 31, 2006		December 31, 2005	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Distribution channels	$ 18,600	$ 11,632	$ 18,173	$ 10,908
Completed technology	5,261	2,532	5,243	2,353
Licenses	2,759	1,970	2,756	1,847
Trademarks	657	249	657	230
Other	4,044	3,180	4,014	2,781
	31,321	$ 19,563	30,843	$ 18,119
Less: Accumulated amortization	(19,563)		(18,119)	
Intangible assets, net	$ 11,758		$ 12,724	

Based on the intangible assets held at March 31, 2006, the Company expects to recognize amortization expense of approximately $4.1 million for the full year of 2006, $3.0 million in 2007, $2.7 million in 2008, $2.5 million in 2009, and $350,000 in 2010.

6. Stock-Based Compensation

In the first quarter of fiscal 2006, the Company adopted FAS 123R, which replaced SFAS No. 123 and supersedes APB No. 25. FAS 123R requires recognition of the fair value of an award of equity instruments granted in exchange for employee services as a cost of those services. Prior to the adoption of FAS 123R, as permitted by SFAS No. 123, the Company accounted for similar transactions in accordance with APB No. 25, which employed the intrinsic value method of measuring compensation cost. Accordingly, compensation cost related to stock option grants to employees was recognized only to the extent that the fair market value of the stock exceeded the exercise price of the stock option at the date of grant.

Effective January 1, 2006, the Company adopted FAS 123R using the modified prospective method. Accordingly, prior year amounts have not been restated. Under the modified prospective method, the provisions of FAS 123R are to be applied to new awards granted after January 1, 2006. For unvested options granted prior to January 1, 2006, the Company is required to recognize, over the remaining vesting period, non-cash stock-based compensation expense for the grant date fair value of the options. FAS 123R did not change the accounting for non-cash stock-based compensation related to non-employees with equity based incentive arrangements.

The Company has two stock-based employee compensation plans which are described below.

Equity Incentive Plan. On December 7, 1999, the Company adopted the 1999 Equity Incentive Plan (the Plan), which was subsequently amended and restated on July 6, 2001, May 13, 2003, May 13, 2004, and May 12, 2005. The Plan authorizes the Company to grant options to purchase up to 9,767,051 shares of common stock. Under the Plan, options to purchase common stock generally are exercisable in increments of 25% annually in each of the first through fourth anniversaries of the date of grant. Options to purchase Series A Preferred Stock that were outstanding at the time the Company completed its IPO in July 2001 became options to purchase the Company s common stock. Those options were immediately exercisable upon their issuance. All the options issued under the plan expire after ten years.

The Company recognized approximately $3.4 million ($2.8 million net of taxes) in non-cash stock-based compensation during the three month period ended March 31, 2006. Further, approximately $297,000 of non-cash stock-based compensation was capitalized as part of the cost of inventory as of March 31, 2006. During the three month period ended March 31, 2005, the Company incurred approximately $212,000 ($128,000 net of taxes) of non-cash stock-based compensation for the fair value of stock options granted to independent distributors and for certain stock options granted to employees where the fair value of the Company s stock exceeded the exercise price of the stock option at the date of grant.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation in the first quarter of 2005 (in thousands, except per share amounts):

Table of Contents

WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

	Three Months Ended March 31, 2005
Net income, as reported	$ 7,269
Add: Stock-based employee compensation cost recognized under intrinsic value method, net of tax	86
Less: Stock-based employee compensation expense determined under fair value based method, net of tax	(2,720)
Pro forma net income	$ 4,635
Income per share:	
Basic, as reported	$ 0.21
Basic, pro forma	$ 0.14
Diluted, as reported	$ 0.21
Diluted, pro forma	$ 0.14

The Company estimates the fair value of stock options using the Black-Scholes valuation model. The Black-Scholes option-pricing model requires the input of estimates, including the expected life of stock options, expected stock price volatility, the risk-free interest rate, and the expected dividend yield. The expected life of options was estimated by calculating the average of the vesting term and the contractual term of the option, as allowed in SEC Staff Accounting Bulletin No. 107 (SAB 107). The expected stock price volatility assumption was estimated based upon historical volatility of the Company s common stock. The risk-free interest rate was determined using U.S. Treasury rates where the term is consistent with the expected life of the stock options. Expected dividend yield is not considered as the Company has never paid dividends and has no plans of doing so in the future. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All stock options are amortized on a straight-line basis over their respective requisite service periods, which are generally the vesting periods.

The weighted-average fair value of the Company s options granted in the first quarter of 2006 and the first quarter of 2005 was $9.70 per share and $12.47 per share, respectively. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option valuation model using the following assumptions:

	Three Months Ended March 31,	
	2006	2005
Risk-free interest rate	4.3% - 4.5%	4.0% - 4.3%
Expected option life	6.25 years	7 years
Expected price volatility	40%	40%

Table of Contents

WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

A summary of the Company s stock option activity is as follows:

	Shares (000)	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life	Aggregate Intrinsic Value* ($000)
Outstanding at December 31, 2005	6,188	$ 19.55		
Granted	130	20.55		
Exercised	(29)	16.36		
Forfeited or expired	(216)	24.20		
Outstanding at March 31, 2006	6,073	$ 19.42	7.1 years	$ 25,665
Exercisable at March 31, 2006	3,160	$ 14.15	5.7 years	$ 25,199

* The aggregate intrinsic value is calculated as the difference between the market value of the Company s common stock as of March 31, 2006, and the exercise price of the shares. The market value as of March 31, 2006 is deemed to have been $19.75 per share, which is the closing sale price of the common stock reported for transactions effected on the Nasdaq National Market on March 31, 2006.

The total intrinsic value of options exercised during the three month periods ended March 31, 2006 and March 31, 2005, was approximately $125,000 and $985,000, respectively.

As of March 31, 2006, the Company had $32.2 million of total unrecognized compensation cost related to unvested stock-based compensation arrangements granted to employees under the Plan. That cost is expected to be recognized over a weighted-average period of 1.7 years.

During the first quarter of 2006 and the first quarter of 2005, the Company granted certain independent distributors common stock options for a total of 26,600 and 26,300 shares, respectively, under the Plan. The distributors were given options to purchase common stock, exercisable in 25% increments on the first through fourth anniversaries of the date of grant, at a weighted-average exercise price of $20.21 and $25.34 per share in the first quarter of 2006 and 2005, respectively. The options expire after ten years.

Employee Stock Purchase Plan. On May 30, 2002, the Company and its shareholders approved and adopted the 2002 Employee Stock Purchase Plan (the ESPP). The ESPP authorizes the Company to issue up to 200,000 shares of common stock to its employees who work at least 20 hours per week. Under the ESPP, there are two six-month plan periods during each calendar year, one beginning January 1 and ending on June 30, and the other beginning July 1 and ending on December 31. Under the terms of the ESPP, employees can choose each plan period to have up to 5% of their annual base earnings, limited to $5,000, withheld to purchase the Company s common stock. The purchase price of the stock is 85 percent of the lower of its beginning-of-period or end-of-period market p