GENENTECH INC
Form 10-Q
May 02, 2006

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: 1-9813

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

Delaware	**94-2347624**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

1 DNA Way, South San Francisco, California 94080-4990
(Address of principal executive offices and Zip Code)

(650) 225-1000
(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 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. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer 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

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock, as of the latest practicable date.

Class	Number of Shares Outstanding
Common Stock $0.02 par value	1,053,627,146 Outstanding at April 26, 2006

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In this report, "Genentech," "we," "us" and "our" refer to Genentech, Inc.; "Common Stock" refers to Genentech's Comm Stock, par value $0.02 per share, "Special Common Stock" refers to Genentech's callable putable Common Stock, par value $0.02 per share, all of which was redeemed by Roche Holdings, Inc. (or "Roche") on June 30, 1999.

We own or have rights to various copyrights, trademarks and trade names used in our business including the following: Activase® (alteplase, recombinant) tissue-plasminogen activator; Avastin® (bevacizumab) anti-VEGF antibody; Cathflo® Activase® (alteplase for catheter clearance); Herceptin® (trastuzumab) anti-HER2 antibody; Lucentis™ (ranibizumab, rhuFab V2) anti-VEGF antibody fragment; Nutropin® (somatropin (rDNA origin) for injection) growth hormone; Nutropin AQ® and Nutropin AQ Pen® (somatropin (rDNA origin) for injection) liquid formulation growth hormone; Nutropin Depot® (somatropin (rDNA origin) for injectable suspension) encapsulated sustained-release growth hormone; Omnitarg™ (pertuzumab) HER dimerization inhibitor; Protropin® (somatrem for injection) growth hormone; Pulmozyme® (dornase alfa, recombinant) inhalation solution; Raptiva® (efalizumab) anti-CD11a antibody; and TNKase® (tenecteplase) single-bolus thrombolytic agent. Rituxan® (rituximab) anti-CD20 antibody is a registered trademark of Biogen Idec Inc.; Tarceva® (erlotinib) is a trademark of OSI Pharmaceuticals, Inc.; and Xolair® (omalizumab) anti-IgE antibody is a trademark of Novartis AG. This report also includes other trademarks, service marks and trade names of other companies.

PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

GENENTECH, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In millions, except per share amounts)
(Unaudited)

	Three Months Ended March 31, 2006	2005
Revenues		
Product sales (including amounts from related parties: 2006-$59; 2005-$54)	$ 1,644	$ 1,186
Royalties (including amounts from a related party: 2006-$167; 2005-$104)	286	232
Contract revenue (including amounts from related parties: 2006-$28; 2005-$26)	56	44
Total operating revenues	1,986	1,462
Costs and expenses		
Cost of sales (including amounts for related parties: 2006 and 2005-$50)	262	256
Research and development (including amounts for related parties: 2006-$53; 2005-$44) (including contract related: 2006-$36; 2005-$27)	374	243
Marketing, general and administrative	441	310
Collaboration profit sharing (including amounts for a related party: 2006-$43; 2005-$24)	226	176
Recurring charges related to redemption	26	35
Special items: litigation-related	13	11
Total costs and expenses	1,342	1,031
Operating income	644	431
Other income (expense):		
Interest and other income, net	53	18
Interest expense	(19)	(3)
Total other income, net	34	15
Income before taxes	678	446
Income tax provision	257	162
Net income	$ 421	$ 284
Earnings per share		
Basic	$ 0.40	$ 0.27
Diluted	$ 0.39	$ 0.27
Shares used to compute basic earnings per share	1,054	1,047
Shares used to compute diluted earnings per share	1,075	1,067

See Notes to Condensed Consolidated Financial Statements

GENENTECH, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions)
(Unaudited)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Cash flows from operating activities		
Net income	$ 421	$ 284
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	96	88
Employee stock-based compensation	74	-
Deferred income taxes	(50)	(21)
Deferred revenue	10	(9)
Litigation-related liabilities	13	13
Tax benefit from employee stock options	-	51
Excess tax benefit from stock-based compensation arrangements	(49)	-
Gain on sales of securities available-for-sale and other	(3)	(1)
Write-down of securities available-for-sale and other	-	4
Changes in assets and liabilities:		
Receivables and other current assets	(96)	(103)
Inventories	(86)	25
Investments in trading securities	(7)	(1)
Accounts payable, other accrued liabilities, and other long-term liabilities	139	55
Net cash provided by operating activities	462	385
Cash flows from investing activities		
Purchases of securities available-for-sale	(454)	(72)
Proceeds from sales and maturities of securities available-for-sale	193	162
Capital expenditures	(253)	(144)
Change in other assets	(13)	(8)
Net cash used in investing activities	(527)	(62)
Cash flows from financing activities		
Stock issuances under employee stock plans	89	106
Stock repurchases	(227)	(156)
Excess tax benefit from stock-based compensation arrangements	49	-
Net cash used in financing activities	(89)	(50)
Net (decrease) increase in cash and cash equivalents	(154)	273
Cash and cash equivalents at beginning of period	1,225	270
Cash and cash equivalents at end of period	$ 1,071	$ 543
Supplemental cash flow data		
Non-cash investing and financing activities		
Capitalization of construction in progress related to financing lease transaction	$ 27	$ 44

Exchange of note receivable for a prepaid royalty and other long-term asset	-	29

See Notes to Condensed Consolidated Financial Statements.

GENENTECH, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In millions)
(Unaudited)

	March 31, 2006	December 31, 2005
Assets		
Current assets		
Cash and cash equivalents	$ 1,071	$ 1,225
Short-term investments	1,213	1,140
Accounts receivable—product sales (net of allowances: 2006-$93; 2005-$83; including amounts from related parties: 2006-$24; 2005-$4)	615	554
Accounts receivable—royalties (including amounts from related party: 2006-$199; 2005-$173)	332	297
Accounts receivable—other (net of allowances: 2006-$1; 2005-$1; including amounts from related parties: 2006-$129; 2005-$132)	187	199
Inventories	804	703
Prepaid expenses and other current assets	311	268
Total current assets	4,533	4,386
Long-term marketable debt and equity securities	1,658	1,449
Property, plant and equipment, net	3,565	3,349
Goodwill	1,315	1,315
Other intangible assets	548	574
Restricted cash and investments	735	735
Other long-term assets	358	339
Total assets	$ 12,712	$ 12,147
Liabilities and stockholders' equity		
Current liabilities		
Accounts payable (including amounts to related parties: 2006-$3; 2005-$1)	$ 328	$ 339
Deferred revenue	45	44
Taxes payable	318	62
Other accrued liabilities (including amounts to related parties: 2006-$148; 2005-$132)	1,059	1,215
Total current liabilities	1,750	1,660
Long-term debt	2,103	2,083
Deferred revenue	229	220
Litigation-related and other long-term liabilities	736	714
Total liabilities	4,818	4,677
Commitments and contingencies		
Stockholders' equity		
Common stock	21	21
Additional paid-in capital	9,468	9,263
Accumulated other comprehensive income	255	253
Accumulated deficit, since June 30, 1999	(1,850)	(2,067)

Total stockholders' equity		7,894		7,470
Total liabilities and stockholders' equity	$	12,712	$	12,147

See Notes to Condensed Consolidated Financial Statements.

GENENTECH, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Summary of Significant Accounting Policies

Basis of Presentation

We prepared the Condensed Consolidated Financial Statements following the requirements of the Securities and Exchange Commission for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States of America (or "GAAP") can be condensed or omitted. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the Consolidated Financial Statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of management, the financial statements include all normal and recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results.

Revenues, expenses, assets and liabilities can vary during each quarter of the year. Therefore, the results and trends in these interim financial statements may not be the same as those expected for the full year or any future period.

Principles of Consolidation

The Condensed Consolidated Financial Statements include the accounts of Genentech and all wholly owned subsidiaries. Material intercompany accounts and transactions have been eliminated.

Use of Estimates and Reclassifications

The preparation of financial statements in conformity with GAAP requires management to make judgments, assumptions and estimates that affect the amounts reported in our Condensed Consolidated Financial Statements and accompanying notes. Actual results could differ materially from those estimates.

Certain reclassifications of prior period amounts have been made to our Condensed Consolidated Financial Statements to conform to the current period presentation.

Earnings Per Share

Basic earnings per share (or "EPS") are computed based on the weighted-average number of shares of our Common Stock outstanding. Diluted EPS are computed based on the weighted-average number of shares of our Common Stock and other dilutive securities.

The following is a reconciliation of the numerators and denominators of the basic and diluted EPS computations *(in millions)*:

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Numerator:		
Net income	$ 421	$ 284

Denominator:		
Weighted-average shares outstanding used to compute basic EPS	1,054	1,047
Effect of dilutive stock options	21	20
Weighted-average shares outstanding and dilutive securities used to compute diluted EPS	1,075	1,067

Employee stock options to purchase approximately 19 million shares of our Common Stock were outstanding in the first quarter of 2006. These employee stock options were excluded from the computation of diluted EPS because the effect would have been anti-dilutive.

Comprehensive Income

Comprehensive income is comprised of net income and other comprehensive income (or "OCI"). OCI includes certain changes in stockholders' equity that are excluded from net income. Specifically, we include in OCI changes in the estimated fair value of derivatives designated as effective cash flow hedges and unrealized gains and losses on our available-for-sale securities.

The components of accumulated OCI, net of taxes, were as follows *(in millions)*:

	March 31, 2006	December 31, 2005
Net unrealized gains on securities available-for-sale	$ 233	$ 230
Net unrealized gains on cash flow hedges	22	23
Accumulated other comprehensive income	$ 255	$ 253

The activity in comprehensive income, net of income taxes, was as follows *(in millions)*:

	Three Months Ended March 31,	
	2006	2005
Net income	$ 421	$ 284
Change in unrealized gains (losses) on securities available-for-sale	3	(77)
Change in unrealized gains (losses) on derivatives	(1)	13
Comprehensive income	$ 423	$ 220

Derivative Financial Instruments

At March 31, 2006, estimated net gains on cash flow hedge derivative instruments, consisting of foreign currency exchange options and marketable equity security collars, expected to be reclassified from accumulated OCI to "other income, net" during the next twelve months are $23 million.

Note 2. Employee Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (or "FAS 123R"), which supersedes our previous accounting under APB Opinion No. 25, "Accounting for Stock Issued to Employees" (or "APB 25"). FAS 123R requires the recognition of compensation expense, using a fair-value based method, for costs related to all share-based payments including stock options and stock issued under our employee stock plans. FAS 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense on a straight-line basis over the requisite service periods in our Condensed Consolidated Statements of Income. Also, certain of these costs are capitalized into inventory on our Condensed Consolidated Balance Sheets, and generally will be recognized as an expense when the related products are sold. We adopted FAS 123R using the modified prospective transition method, which requires that compensation expense be recognized in the financial statements for all awards granted after the date of adoption as well as for existing awards for which the requisite service has not been rendered as of the date of adoption. The modified prospective transition method does not require restatement of prior periods to reflect the impact of FAS 123R.

In November 2005, the Financial Accounting Standards Board (or “FASB”) issued FSP No. 123R-3, “Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards.” We have adopted the simplified method to calculate the beginning balance of the additional paid-in-capital (or “APIC”) pool of the excess tax benefit, and to determine the subsequent impact on the APIC pool and Condensed Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that were outstanding upon our adoption of FAS 123R.

Prior to the adoption of FAS 123R, we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under FAS No. 123, "Accounting for Stock-Based Compensation" (or "FAS 123"). Under the intrinsic value method, no employee stock-based compensation expense had been recognized in our Condensed Consolidated Statements of Income for any period prior to our adoption of FAS 123R on January 1, 2006, as the exercise price of the stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Employee Stock Plans

We currently have an employee stock purchase plan, adopted in 1991 and amended thereafter (or "the 1991 Plan"). The 1991 Plan allows eligible employees to purchase Common Stock at 85% of the lower of the fair market value of the Common Stock on the grant date or the fair market value on the purchase date. The offering period under the 1991 Plan is currently 15 months, and the purchase price is established during each new offering period. Purchases are limited to 15% of each employee's eligible compensation and subject to certain Internal Revenue Service restrictions. All of our full-time employees are eligible to participate in the 1991 Plan. Of the 52,400,000 shares of Common Stock reserved for issuance under the 1991 Plan, 45,640,634 shares have been issued as of March 31, 2006.

We currently grant options under a stock option plan adopted in 1999 and amended thereafter (or "the 1999 Plan"), that allows for the granting of non-qualified stock options, incentive stock options and stock purchase rights to our employees, directors and consultants. Incentive stock options may only be granted to employees under this plan. Generally, non-qualified options and incentive options have a maximum term of 10 years, and options vest in increments over four years from the date of grant, although we may grant options with different vesting terms from time to time. When an employee over the age of 65 retires, the number of options that would have vested in the 12 month period following the retirement date, if the retiree had remained an employee, automatically becomes fully vested. The expiration date of the exercisable options remains the original expiration date at the time the options were granted. Upon employee termination, unexercised options will expire at the end of three months. No stock purchase rights or incentive stock options have been granted under the 1999 Plan to date.

Adoption of FAS 123R

Employee stock-based compensation expense recognized in the first quarter of 2006 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. FAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Employee stock-based compensation expense recognized under FAS 123 was as follows *(in millions, except for per share data):*

	Three Months Ended March 31, 2006
Research and development	$ 33
Marketing, general and administrative	41
Total employee stock-based compensation expense	74
Tax benefit related to employee stock-based compensation expense	(27)

Net effect on net income	$	47
Effect on earnings per share:		
Basic	$	0.04
Diluted	$	0.04

As of March 31, 2006, total compensation cost related to nonvested stock options not yet recognized was $734 million, which is expected to be allocated to expense and production costs over a weighted-average period of 27 months.

The carrying value of inventory on our Condensed Consolidated Balance Sheet as of March 31, 2006 includes employee stock-based compensation costs of $16 million. Substantially all of the products sold in the first quarter of 2006 were manufactured in previous periods when we did not include employee stock-based compensation expense in our production costs. In future periods, when product manufactured after the adoption of FAS 123R is sold or written off, or reserves are required for obsolescence or lack of demand, we will recognize employee stock-based compensation expense in cost of sales.

The following pro forma net income and EPS were determined as if we had accounted for employee stock-based compensation for our employee stock plans under the fair value method prescribed by FAS 123 in prior periods and had capitalized certain costs into inventory manufactured in those prior periods, with the resulting impact on cost of sales for the quarter ended March 31, 2006 when previously manufactured products were sold. *(In millions, except for per share data)*:

		Three Months Ended March 31, 2006
Net income as reported	$	421
Deduct: Total employee stock-based compensation expense includable in cost of sales, net of related tax effects		(8)
Pro forma net income	$	413
Earnings per share:		
Basic-as reported	$	0.40
Basic-pro forma	$	0.39
Diluted-as reported	$	0.39
Diluted-pro forma	$	0.38

Pro Forma Information for Period Prior to Adoption of FAS 123R

The following pro forma net income and EPS were determined as if we had accounted for employee stock-based compensation for our employee stock plans under the fair value method prescribed by FAS 123. *(In millions, except for per share data)*:

		Three Months Ended March 31, 2005
Net income as reported	$	284
Deduct: Total employee stock-based compensation expense determined under the fair value based method for all awards, net of related tax effects		(40)
Pro forma net income	$	244
Earnings per share:		
Basic-as reported	$	0.27
Basic-pro forma	$	0.23
Diluted-as reported	$	0.27
Diluted-pro forma	$	0.22

Valuation Assumptions

The employee stock-based compensation expense recognized under FAS 123R and presented in the pro forma disclosure required under FAS 123 was determined using the Black-Scholes option valuation model. Option valuation models require the input of subjective assumptions and these assumptions can vary over time. The weighted-average assumptions used are as follows:

	Three Months Ended March 31,	
	2006	**2005**
Risk-free interest rate	4.6%	4.0%
Dividend yield	0.0%	0.0%
Expected volatility	29.0%	32.0%
Expected term (years)	4.2	4.2

Due to the redemption of our Special Common Stock in June 1999 by Roche, there is limited historical information available to support our estimate of certain assumptions required to value our employee stock options and the stock issued under our employee stock purchase plan. In developing our estimate of expected term, we have determined that our historical stock option exercise experience is a relevant indicator of future exercise patterns. We also take into account other available information, including industry averages. We primarily base our determination of expected volatility through our assessment of the implied volatility of our Common Stock. Implied volatility is the volatility assumption inherent in the market prices of a company’s traded options.

Stock Option Activity

The following is a summary of option activity for the first quarter of 2006 *(shares in millions)*:

		Options Outstanding	
	Shares Available for Grant	**Number of Shares**	**Weighted-Average Exercise Price**
December 31, 2005	84	83	$ 46.64
Grants	(1)	1	88.10
Exercises	-	(2)	30.38
Cancellations	1	(1)	57.63
March 31, 2006	84	81	$ 47.43

The intrinsic value of options exercised during the first quarters of 2006 and 2005 was $125 million and $117 million, respectively. The estimated fair value of shares vested during the first quarters of 2006 and 2005 was $90 million and $40 million, respectively. The weighted-average estimated fair value of stock options granted during the three months ended March 31, 2006 and 2005 was $27.34 and $15.95, respectively, based on the assumptions in the Black-Scholes valuation model discussed above.

The following table summarizes outstanding and exercisable options at March 31, 2006 *(in millions, except exercise price data)*:

	Options Outstanding			**Options Exercisable**		
Range of Exercise Prices	**Number of Shares Outstanding**	**Weighted-Average Remaining Contractual Life** (in years)	**Weighted-Average Exercise Price**	**Number of Shares Outstanding**	**Weighted-Average Remaining Contractual Life** (in years)	**Weighted-Average Exercise Price**