VCA ANTECH INC
Form 10-Q
November 08, 2006

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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, 2006

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

Commission File Number: 001-16783

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

Delaware	**95-4097995**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

12401 West Olympic Boulevard
Los Angeles, California 90064-1022
(Address of principal executive offices)
(310) 571-6500
(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: common stock, $0.001 par value 83,498,763 shares as of November 3, 2006.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

VCA ANTECH, INC. AND SUBSIDIARIES
CONDENSED, CONSOLIDATED BALANCE SHEETS
As of September 30, 2006 and December 31, 2005
(Unaudited)
(In thousands, except par value)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 32,821	$ 58,488
Trade accounts receivable, less allowance for uncollectible accounts of $11,100 and $9,409 at September 30, 2006 and December 31, 2005, respectively	41,091	36,104
Inventory	20,483	17,856
Prepaid expenses and other	12,315	9,867
Deferred income taxes	11,850	10,972
Prepaid income taxes	18,235	12,337
Total current assets	136,795	145,624
Property and equipment, less accumulated depreciation and amortization of $106,551 and $93,305 at September 30, 2006 and December 31, 2005, respectively	159,287	143,781
Other assets:		
Goodwill	615,784	586,444
Other intangible assets, net	15,006	10,735
Deferred financing costs, net	1,041	1,340
Other	10,459	9,149
Total assets	$ 938,372	$ 897,073
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term obligations	$ 6,620	$ 5,884
Accounts payable	18,021	20,718
Accrued payroll and related liabilities	28,203	30,131
Accrued interest	314	306
Other accrued liabilities	28,778	23,930
Total current liabilities	81,936	80,969
Long-term obligations, less current portion	385,403	446,828
Deferred income taxes	38,267	30,803
Other liabilities	13,975	19,775

Minority interest		10,181		9,947
Commitments and contingencies				
Preferred stock, par value $0.001, 11,000 shares authorized, none outstanding				
Stockholders equity:				
Common stock, par value $0.001, 175,000 shares authorized, 83,460 and 82,759 shares outstanding as of September 30, 2006 and December 31, 2005, respectively		83		83
Additional paid-in capital		272,603		258,402
Retained earnings		135,246		49,057
Accumulated other comprehensive income		678		1,209
Total stockholders equity		408,610		308,751
Total liabilities and stockholders equity	$	938,372	$	897,073

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

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VCA ANTECH, INC. AND SUBSIDIARIES
CONDENSED, CONSOLIDATED INCOME STATEMENTS
For the Three and Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(In thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenue	$ 251,632	$ 229,242	$ 740,962	$ 622,689
Direct costs	181,167	166,598	532,014	448,783
Gross profit	70,465	62,644	208,948	173,906
Selling, general and administrative expense	18,946	18,394	57,315	47,943
Loss (gain) on sale of assets	3	115	(200)	27
Operating income	51,516	44,135	151,833	125,936
Interest expense, net	6,084	6,034	18,323	18,782
Debt retirement costs				19,282
Other expense (income)	73	(130)	(24)	1
Minority interest in income of subsidiaries	846	778	2,520	2,309
Income before provision for income taxes	44,513	37,453	131,014	85,562
Provision for income taxes	17,536	15,196	44,825	34,797
Net income	$ 26,977	$ 22,257	$ 86,189	$ 50,765
Basic earnings per common share	$ 0.32	$ 0.27	$ 1.04	$ 0.62
Diluted earnings per common share	$ 0.32	$ 0.26	$ 1.02	$ 0.61
Shares used for computing basic earnings per share	83,339	82,526	83,092	82,364
Shares used for computing diluted earnings per share	85,187	84,019	84,864	83,818

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

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VCA ANTECH, INC. AND SUBSIDIARIES
CONDENSED, CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2006 and 2005
(Unaudited)
(In thousands)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Cash flows from operating activities:		
Net income	$ 86,189	$ 50,765
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	16,347	13,947
Amortization of debt costs	299	482
Provision for uncollectible accounts	4,174	2,996
Debt retirement costs		19,282
Loss (gain) on sale of assets	(200)	27
Share-based compensation	2,326	
Minority interest in income of subsidiaries	2,520	2,309
Distributions to minority interest partners	(2,439)	(1,968)
Deferred income taxes	7,222	4,029
Excess tax benefit from exercise of stock options	(5,774)	
Other	(750)	(337)
Changes in operating assets and liabilities:		
Increase in accounts receivable	(8,500)	(7,009)
Increase in inventory, prepaid expenses and other assets	(6,816)	(5,796)
Increase (decrease) in accounts payable and other accrued liabilities	(2,507)	4,439
Decrease in accrued payroll and related liabilities	(1,928)	(3,862)
Increase (decrease) in accrued interest	8	(1,251)
Decrease in prepaid income taxes	567	13,161
Net cash provided by operating activities	90,738	91,214
Cash flows from investing activities:		
Business acquisitions, net of cash acquired	(37,612)	(83,702)
Real estate acquired in connection with business acquisitions	(2,872)	(2,929)
Property and equipment additions	(23,800)	(22,725)
Proceeds from sale of assets	533	368
Other	268	3,540
Net cash used in investing activities	(63,483)	(105,448)
Cash flows from financing activities:		
Repayment of long-term obligations	(64,106)	(445,721)
Proceeds from the issuance of long-term obligations		475,000
Payment of financing costs		(3,257)
Proceeds from issuance of common stock under stock option plans	5,410	1,749
Excess tax benefit from exercise of stock options	5,774	

Net cash provided by (used in) financing activities	(52,922)	27,771
Increase (decrease) in cash and cash equivalents	(25,667)	13,537
Cash and cash equivalents at beginning of period	58,488	30,964
Cash and cash equivalents at end of period	$ 32,821	$ 44,501

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

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VCA ANTECH, INC. AND SUBSIDIARIES
NOTES TO CONDENSED, CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2006
(Unaudited)

1. General

The accompanying unaudited, condensed, consolidated financial statements of our company, VCA Antech, Inc. and subsidiaries, have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the rules and regulations of the United States Securities and Exchange Commission. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles in the United States for annual financial statements as permitted under applicable rules and regulations. In the opinion of our management, all normal recurring adjustments considered necessary for a fair presentation have been included. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the results to be expected for the full year. For further information, refer to our consolidated financial statements and notes thereto included in our 2005 annual report on Form 10-K.

The preparation of our condensed, consolidated financial statements in accordance with generally accepted accounting principles in the United States requires our management to make estimates and assumptions that affect the amounts reported in our condensed, consolidated financial statements and notes thereto. Actual results could differ from those estimates.

2. Acquisitions

During the nine months ended September 30, 2006, we acquired 17 animal hospitals, four of which were merged into existing animal hospitals, two laboratories, one of which was merged into an existing laboratory, and a lab-related business that we will utilize in our laboratory operations. The following table summarizes the aggregate consideration, including acquisition costs, paid by us for those acquisitions that occurred during the nine months ended September 30, 2006 and the allocation of the purchase price (in thousands):

Consideration:	
Cash	$ 35,812
Notes payable and other liabilities assumed	4,844
Total	$ 40,656
Purchase Price Allocation:	
Tangible assets	$ 4,371
Identifiable intangible assets (1)	6,932
Goodwill (2)	29,353
Total	$ 40,656

(1) The acquired identifiable intangible assets have a weighted-average useful life of approximately 19 years and are comprised of

non-contractual customer relationships of $4.9 million (25-year weighted-average useful life), covenants not-to-compete of $2.0 million (five-year weighted-average useful life) and client lists of $14,000 (three-year weighted-average useful life).

(2) We expect that $25.6 million of the goodwill recorded for these acquisitions will be fully deductible for income tax purposes.

Other Acquisition Payments

In connection with certain acquisitions, we withheld a portion of the purchase price, or the holdback, as security for indemnification obligations of the sellers under the acquisition agreement. We paid $1.7 million to sellers for the unused portion of holdbacks during the nine months ended September 30, 2006.

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3. Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquired entity over the net of the amounts assigned to identifiable assets acquired and liabilities assumed. The following table presents the changes in the carrying amount of our goodwill for the nine months ended September 30, 2006 (in thousands):

	Laboratory	Animal Hospital	Medical Technology	Total
Balance as of December 31, 2005	$ 94,246	$ 473,038	$ 19,160	$ 586,444
Goodwill acquired	877	28,476		29,353
Other (1)		8		8
Goodwill related to sale of animal hospitals		(21)		(21)
Balance as of September 30, 2006	$ 95,123	$ 501,501	$ 19,160	$ 615,784

(1) Comprised of purchase price adjustments.

In addition to goodwill, we have amortizable intangible assets at September 30, 2006 and December 31, 2005 as follows (in thousands):

	September 30, 2006			December 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Covenants not-to-compete	$ 12,231	$ (5,761)	$ 6,470	$ 11,145	$ (4,970)	$ 6,175
Non-contractual customer relationships	8,313	(1,346)	6,967	3,235	(701)	2,534
Technology	1,270	(504)	766	1,270	(314)	956
Trademarks	569	(113)	456	569	(70)	499
Contracts	397	(207)	190	397	(129)	268
Client lists	464	(307)	157	461	(158)	303
Total	$ 23,244	$ (8,238)	$ 15,006	$ 17,077	$ (6,342)	$ 10,735

The following table summarizes our aggregate amortization expense related to other intangible assets (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Aggregate amortization expense	$ 933	$ 796	$ 2,661	$ 2,393

The estimated amortization expense related to intangible assets for each of the five succeeding years and thereafter as of September 30, 2006 is as follows (in thousands):

Remainder of 2006	$ 906
2007	3,398
2008	2,777

2009	1,733
2010	997
Thereafter	5,195
Total	$ 15,006

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4. Share-Based Compensation Plans

Stock Incentive Plans

At September 30, 2006, there were 5,389,377 shares of common stock issuable upon exercise of outstanding options granted under our existing stock incentive plans. We maintain three plans, the 1996 Stock Incentive Plan, or the 1996 Plan, the 2001 Stock Incentive Plan, or the 2001 Plan, and the 2006 Equity Incentive Plan, or the 2006 Plan. New options and other stock awards may only be granted under the 2006 Plan. The maximum aggregate number of shares of common stock that may be issued under the 2006 Plan to our employees, directors, consultants and those of our affiliates is (a) 6,490,412 shares of common stock; plus (b) any shares of common stock underlying prior outstanding options that expire, are forfeited, cancelled or terminate for any reason without having been exercised in full. At September 30, 2006, all of these shares were available for grant. Outstanding options granted under our plans typically vest over periods that range from two to four years and expire between seven and ten years from the date of grant.

Adoption of SFAS No. 123R

Prior to January 1, 2006, we accounted for our share-based payments under the intrinsic value method as prescribed in Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees.* Under that method, when options are granted with a strike price equal to or greater than market price on date of issuance, there is no impact on earnings either on the date of grant or thereafter, absent modification to the options. Accordingly, we recognized no share-based compensation expense in periods prior to January 1, 2006.

Effective January 1, 2006, we adopted Statement of Financial Accounting Standards, or SFAS, No. 123R, *Share-Based Payment*. SFAS No. 123R requires us to measure the cost of share-based payments granted to our employees and directors, including stock options, based on the grant-date fair value and to recognize the cost over the requisite service period, which is typically the vesting period. We adopted SFAS No. 123R using the modified prospective transition method, which requires us to recognize compensation expense for share-based payments granted or modified on or after January 1, 2006. Additionally, we are required to recognize compensation expense for the fair value of unvested share-based awards at January 1, 2006 over the remaining requisite service period. Operating results from prior periods have not been restated.

The effect of adopting SFAS No. 123R on our condensed, consolidated financial statements for the three and nine months ended September 30, 2006 is as follows (in thousands, except per share amounts):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Share-based compensation:		
Laboratory direct cost	$ 172	$ 492
Laboratory selling, general and administrative expense	128	382
Animal hospital selling, general and administrative expense	376	807
Corporate selling, general and administrative expense	205	645
	881	2,326
Tax benefit	(334)	(878)
Net decrease in net income	$ 547	$ 1,448
Effect on:		
Basic earnings per common share	$ 0.01	$ 0.01
Diluted earnings per common share	$	$ 0.01

Effect on:		
Cash flows from operating activities	$	(5,774)
Cash flows from financing activities	$	5,774

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No share-based compensation was recognized during the three and nine months ended September 30, 2005, however, the following table presents net income and earnings per common share as if we had recognized share-based compensation using the fair-value-based method (in thousands, except per share amounts):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	$ 22,257	$ 50,765
Deduct: Total share-based compensation determined under fair-value-based method for all awards, net of tax	(503)	(4,457)
Pro forma net income	$ 21,754	$ 46,308
Earnings per common share:		
Basic as reported	$ 0.27	$ 0.62
Basic pro forma	$ 0.26	$ 0.56
Diluted as reported	$ 0.26	$ 0.61
Diluted pro forma	$ 0.26	$ 0.55

Prior to the adoption of SFAS No. 123R, we reported all income tax benefits resulting from the exercise of stock options as cash provided by operating activities on our condensed, consolidated statements of cash flows. SFAS No. 123R requires the benefits of tax deductions from the exercise of options in excess of the compensation cost for those options to be classified as cash provided by financing activities. As such, the $5.8 million excess tax benefit classified as a financing activity on our condensed, consolidated statement of cash flows for the nine months ended September 30, 2006 would have been recognized as an operating activity if we had not adopted SFAS No. 123R.

Calculation of Fair Value

The fair value of our options is estimated on the date of grant using the Black-Scholes option pricing model. We amortize the fair value of our options on a straight-line basis over the requisite service period. There were 39,341 options granted during the nine months ended September 30, 2006 with a weighted-average fair value of $10.97. The weighted-average fair value of options granted during the nine months ended September 30, 2005 was $8.05. No options were granted during the three months ended September 30, 2006 and 2005. The following assumptions were used to determine the fair value of those options granted during the nine months ended September 30, 2006 and 2005:

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Expected volatility (1)	35.5%	39.1% to 39.6%
Weighted-average volatility (1)	35.5%	39.5%
Expected dividends	0.0%	0.0%
Expected term (2)	4.3 years	5 years
Risk-free rate (3)	4.99%	3.9% to 4.2%

(1) We estimate the volatility of our common stock on the date of

grant based on historical volatility.

(2) The expected term represents the period of time that we expect the options to be outstanding. We estimated the expected term based on the simplified method permitted under SEC Staff Accounting Bulletin, or SAB, No. 107.

(3) The risk-free interest rate is based on the implied yield in effect at the time of option grant on U.S. Treasury zero-coupon issues with equivalent remaining terms.

We use historical data to estimate pre-vesting option forfeitures. We recognize share-based compensation only for those awards that we expect to vest.

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Stock Option Activity

A summary of our stock option activity for all share-based compensation plans during the nine months ended September 30, 2006 is as follows (in thousands, except weighted-average exercise price and weighted-average remaining contractual term):