ORTHODONTIC CENTERS OF AMERICA INC /DE/
Form 10-Q
May 15, 2003

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

FORM 10-Q

[X] **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2003, OR**

[ ] **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM ____ TO ____.**

Commission File No.: 001-13457

ORTHODONTIC CENTERS OF AMERICA, INC.

(Exact name of registrant as specified in its charter)

Delaware	72-1278948
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3850 N. Causeway Boulevard, Suite 800
Metairie, Louisiana 70002
(504) 834-4392
(Address, including zip code, of principal executive offices and
Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 X NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES X NO __

At May 12, 2003 there were approximately 50,236,000 outstanding shares of the Registrant s Common Stock, $.01 par value per share.

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FORWARD-LOOKING STATEMENTS

Certain statements contained in this Report may not be based on historical facts and are 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. These forward-looking statements may be identified by reference to a future period(s) or by the use of forward looking terminology, such as anticipate, estimate, believe, expect, foresee, may, would, could or will. These forward-looking statements include, without limitation, stateme the Company s future growth and operating results, fee revenue, service fees receivable, critical accounting policies and estimates, net operating loss carryforwards, payments to OrthAlliance affiliated practices under incentive programs, allowance for uncollectible amounts, capital expenditures, liquidity, capital resources, cash needs, buy-outs of service, consulting and management service agreements, pending litigation against OrthAlliance and the Company, advancement of funds to affiliated practices, repayment of outstanding indebtedness and impairment of goodwill. We caution you not to place undue reliance on these forward-looking statements, in that they involve certain risks and uncertainties that could cause actual results to differ materially from anticipated results. These risks and uncertainties include potential adverse changes in the Company s financial results and conditions, disruption of the Company s relationships with its affiliated practices or loss of a significant number of the Company s affiliated practices, failure or delay in integrating OrthAlliance s affiliated practices, adverse outcomes of litigation pending against the Company and OrthAlliance, competition, inability to effectively manage an increasing number of affiliated practices, changes in the general economy of the United States and the specific markets in which the Company operates, risks relating to the Company s foreign operations, changes in the Company s operating or expansion strategy, inability of the Company to attract and retain qualified personnel and affiliated practitioners, inability of the Company to effectively market its services and those of its affiliated practices, changes in regulations affecting the Company s business, and other factors identified in the Company s Annual Report on Form 10-K for the year ended December 31, 2002, other filings with the Securities and Exchange Commission or in other public announcements by the Company. We undertake no obligation to update these forward-looking statements to reflect events or circumstances that occur after the date of this Report.

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PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

Orthodontic Centers of America, Inc.
Consolidated Balance Sheets
(in thousands, except share amounts)

	March 31, 2003	December 31, 2002
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 12,126	$ 7,522
Current portion of service fees receivable, net of allowance for uncollectible amounts of $5,271 at March 31, 2003 and $5,095 at December 31, 2002	73,623	63,448
Current portion of advances to affiliated practices, net of allowance for uncollectible amounts of $2,661 at March 31, 2003 and $2,406 at December 31, 2002	14,580	14,857
Deferred income taxes	28,685	37,572
Supplies inventory	12,489	12,526
Prepaid expenses and other assets	7,120	7,439
Total current assets	148,623	143,364
Unreimbursed expense portion of service fees receivable	44,605	43,070
Advances to affiliated practices, less current portion, net	15,796	15,687
Property, equipment and improvements, net	90,476	90,060
Intangible assets, net	218,270	220,383
Goodwill	87,641	87,641
Other assets	11,589	7,040
TOTAL ASSETS	$617,000	$607,245
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 6,424	$ 8,048
Accrued salaries and other accrued liabilities	18,153	20,620
Deferred revenue	537	713
Service fee prepayments	5,296	7,743
Current portion of notes payable to affiliated practices	6,973	8,387
Current portion of long-term debt	10,415	8,333
Total current liabilities	47,798	53,844
Deferred income tax liabilities	8,030	8,030
Notes payable to affiliated practices, less current portion	3,683	4,612
Long-term debt, less current portion	99,483	97,899
Shareholders equity:		
Preferred stock, $.01 par value: 10,000,000 shares authorized; no shares outstanding		
Common stock, $.01 par value: 100,000,000 shares authorized; approximately 51,318,000 shares issued and outstanding at March 31, 2003 and 51,268,000 shares issued and outstanding at December 31, 2002	513	512
Additional paid-in capital	218,244	217,840

Retained earnings	255,816	240,911
Accumulated other comprehensive loss	(1,586)	(1,376)
Less cost of approximately 1,093,000 shares of treasury stock at March 31, 2003 and 1,097,000 at December 31, 2002	(14,981)	(15,027)
Total shareholders equity	458,006	442,860
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	$617,000	$607,245

See accompanying notes to consolidated financial statements.

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Orthodontic Centers of America, Inc.
Consolidated Statements of Income
(in thousands, except per share data)

	Three months ended March 31, 2003	Three months ended March 31, 2002
	(Unaudited)	
Fee revenue	$100,639	$111,323
Direct expenses:		
Employee costs	29,301	31,827
Orthodontic supplies	10,596	9,578
Rent	9,503	10,075
Marketing and advertising	6,242	8,950
Total direct expenses	55,642	60,430
General and administrative	12,949	14,404
Depreciation	3,933	2,815
Amortization	2,728	2,640
Operating profit	25,387	31,034
Interest income (expense), net	(1,429)	(1,348)
Non-controlling interest in subsidiary	(14)	23
Income before income taxes	23,944	29,709
Income taxes	9,039	11,215
Net income	$ 14,905	$ 18,494
Net income per share:		
Basic	$ 0.30	$ 0.36
Diluted	$ 0.30	$ 0.36
Average shares outstanding:		
Basic	50,197	50,969
Diluted	50,402	51,787

See accompanying notes to consolidated financial statements.

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Orthodontic Centers of America, Inc.
Consolidated Statements of Cash Flows
(in thousands)

	Three months ended March 31, 2003	Three months ended March 31, 2002
	(Unaudited)	
Operating activities:		
Net income	$ 14,905	$ 18,494
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for bad debt expense	644	171
Depreciation and amortization	6,661	5,455
Deferred income taxes	8,887	(380)
Changes in operating assets and liabilities:		
Service fees receivable	(11,886)	(8,430)
Service fee prepayments	(2,447)	(665)
Supplies inventory	37	1,242
Prepaid expenses and other	351	(44)
Amounts payable to affiliated practices		(417)
Accounts payable and other current liabilities	(4,268)	6,106
Net cash provided by operating activities	12,884	21,532
Investing activities:		
Purchases of property, equipment and improvements	(4,349)	(4,747)
Intangible assets acquired	(286)	(2,510)
Advances to affiliated practices, net	(300)	(2,740)
Notes receivable	(1,172)	158
Net cash used in investing activities	(6,107)	(9,839)
Financing activities:		
Repayment of notes payable to affiliated practices	(2,628)	(3,822)
Repayment of long-term debt	(109,640)	(5,000)
Proceeds from long-term debt	109,900	
Issuance of common stock	405	1,297
Net cash used in financing activities	(1,963)	(7,525)
Effect of exchange rate changes on cash and cash equivalents	(210)	(1,840)
Change in cash and cash equivalents	4,604	2,328
Cash and cash equivalents at beginning of period	7,522	14,172
Cash and cash equivalents at end of period	$ 12,126	$ 16,500
Supplemental cash flow information:		
Cash paid during period for:		
Interest	$ 1,392	$ 1,205
Income taxes	$ 77	$ 53
Supplemental disclosures of non-cash investing and financing activities:		
Notes payable and common stock issued to obtain Service Agreements	$ 284	$

See accompanying notes to consolidated financial statements.

Orthodontic Centers of America, Inc.

Notes to Consolidated Financial Statements (Unaudited)

March 31, 2003

1. DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Orthodontic Centers of America, Inc. (the Company) provides business services to orthodontic and pediatric dental practices in 46 states and four foreign markets.

The Company provides purchasing, financial, marketing and administrative services under service, consulting and management service agreements (Service Agreements). The Company provides services to orthodontic and pediatric dental practices operated by orthodontists and pediatric dentists and/or their wholly-owned professional entities (Affiliated Practices). Because the Company does not control the Affiliated Practices, it does not consolidate their financial results. The following table provides information about the Company s Affiliated Practices as of March 31, 2003:

	Number of Affiliated Practices		
Location	**Orthodontic**	**Pediatric**	**Total**
United States	309	29	338
Japan	24		24
Mexico	4		4
Puerto Rico	2		2
Spain	3		3
Total	342	29	371

These amounts exclude 42 affiliated orthodontic and pediatric dental practices that are in litigation with, and have stopped paying service fees to, OrthAlliance, Inc. (OrthAlliance) as of March 31, 2003. The Company acquired OrthAlliance in November 2001.

The Company s consolidated financial statements include service fees earned under the Service Agreements and the expenses of providing the Company s services. These expenses generally include all practice-related expenses of the Affiliated Practices, excluding the practitioners compensation and professional insurance coverage.

Certain reclassifications have been made to the March 31, 2002 financial statements in order to conform to the presentation of the March 31, 2003 financial statements.

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for audited financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. Operating results for the three month period ended March 31, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2002.

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2. REVENUE RECOGNITION

Fee revenue consists of amounts earned by the Company under the Service Agreements and recognized under the Company s revenue recognition policy. The Company recognizes fee revenue as follows: (A) the Company allocates the total amount of patient fees payable under a patient contract of an Affiliated Practice on a straight-line basis over the term of the patient contract (which generally averages about 26 months); (B) the Company then reduces that allocated amount by the portion that is retained or to be retained by Affiliated Practices (Amounts Retained By Affiliated Practices), which consists of (i) amounts collected in the relevant period and retained by Affiliated Practices under the terms of their Service Agreements and (ii) amounts not collected in the relevant period that the Company estimates will be retained by Affiliated Practices in future periods; and (C) the Company then offsets a portion of Amounts Retained By Affiliated Practices by adding amounts related to certain unreimbursed practice-related expenses incurred on behalf of Affiliated Practices and recorded as expenses in the Company s consolidated statements of income. The Company recognizes these expense amounts as fee revenue to the extent Affiliated Practices generate sufficient patient fees receivable to secure reimbursement of the expenses.

Until amounts related to unreimbursed practice-related expenses are recognized as fee revenue under the Company s revenue recognition policy, the Company s rights to receive reimbursement for these expenses are not recorded on the Company s balance sheet as service fees receivable, even though Affiliated Practices have a contractual obligation to reimburse the Company.

Under most of the Company s Service Agreements, service fees are calculated based upon an allocation of a specified percentage of patient contract balances during the first month of treatment with the remainder allocated equally over the remaining term of the patient contracts, less amounts retained by Affiliated Practices. Because the Company recognizes fee revenue based on a straight-line allocation of patient contract balances, this may result in the Company recognizing a portion of its fee revenue after corresponding service fees have become contractually due under the Company s Service Agreements.

Many of OrthAlliance s Affiliated Practices require that their patients pay a down payment of approximately 25% of the total treatment fee at the commencement of treatment. Because the Company recognizes fee revenue based on a straight-line allocation of patient contract balances, this results in the Company receiving cash in advance of recognizing certain fee revenue. The Company records these amounts as service fee prepayments and defers recognition of these amounts as fee revenue until they are recognized under the Company s revenue recognition policy.

3. SERVICE FEES RECEIVABLE

Service fees receivable represents fee revenue owed to the Company by its Affiliated Practices. Service fees receivable consists of three categories of fee revenue: (A) fee revenue related to patient fees receivable that have been billed to patients or third party payors (billed patient fees receivable); (B) fee revenue related to patient fees receivable that have not yet been billed to patients or third party payors (unbilled patient fees receivable); and (C) fee revenue related to certain unreimbursed practice-related expenses the Company has incurred on behalf of Affiliated Practices and recorded as expenses.

The Company recognizes fee revenue based in part on a straight-line allocation of Affiliated Practices patient contract balances over the terms of the patient contracts. This straight-line allocation includes billed patient fees receivable and unbilled patient fees receivable. A portion of the Company s fee revenue also relates to certain unreimbursed practice-related expenses incurred on behalf of Affiliated Practices and recorded as expenses in the Company s consolidated statements of income. The Company generally collects its service fees receivable when patient fees are billed and collected by or on behalf of the Company s Affiliated Practices.

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Service fees receivable are comprised of a current and long-term component. The current portion of service fees receivable consists of fee revenue related to billed patient fees receivable and unbilled patient fees receivable. The long-term component is the unreimbursed expense portion of service fee receivables, for which the Company is generally reimbursed over a five-year period.

Current Portion of Service Fees Receivable:

Fee revenue related to billed patient fees receivable. Fee revenue related to billed patient fees receivable generally increases due to increases in the aggregate dollar amount of Affiliated Practices patient contracts, both from increases in the overall number of patient contracts and increases in the average amount of treatment fees charged per patient by Affiliated Practices, as well as increases in the average number of days between billing and collection of patient fees.

Fee revenue related to unbilled patient fees receivable. The Company recognizes fee revenue based in part on a straight-line allocation of the patient contract balances of Affiliated Practices over the terms of the patient contracts (which average about 26 months). However, Affiliated Practices generally do not bill their patients on a straight-line basis. Rather, most Affiliated Practices use the Company s recommended payment plan for their patients, which results in a disproportionate amount of patient fees being billed and collected at the end of the treatment term. This generally results in an increasing amount of service fees receivable over a patient s term of treatment.

The Company s recommended payment plan provides for no down payment, an initial record fee, equal monthly installments and a final retainer fee. The initial record fee is generally billed in the first month of treatment (along with one of the monthly installments) and is generally equal to the amount of one monthly installment. The final retainer fee is generally billed and collected in the final month of treatment and is generally equal to four times the monthly installment amount.

Under the Company s revenue recognition policy, service fees relating to a patient contract, including the initial record fee and the final retainer fee, are recognized as fee revenue evenly over the course of the patient s treatment, even though the initial record fee and the final retainer fee are generally billed and collected at the beginning and end of treatment, respectively. Payment of the initial record fee generally results in a service fee prepayment, because it is collected before the Company recognizes all of the related fee revenue. In contrast, the final retainer fee generally results in service fees receivable, because the Company recognizes related fee revenue before it is billed or collected. These service fees receivable gradually accumulate over the course of treatment until the final retainer fee is billed and collected in the final month.

Unreimbursed Expense Portion of Service Fees Receivable:

Fee revenue related to reimbursable practice-related expenses. A portion of the Company s fee revenue represents reimbursement of certain practice-related expenses incurred on behalf of Affiliated Practices and recorded as expenses in the Company s consolidated statements of income. The Company generally recognizes fee revenue relating to these expenses to the extent that Affiliated Practices generate sufficient patient fees receivable to secure reimbursement of the expenses.

Under the terms of most of the Company s Service Agreements, Affiliated Practices generally reimburse the Company for certain practice-related expenses over a five-year period. These expenses include operating losses and other expenses for newly-developed or *de novo* centers (including those developed by existing practices), and depreciation expense related to property, equipment and improvements for existing and *de novo* centers. This generally results in an increasing amount of service fees receivable as the reimbursable practice-related expenses are recognized as fee revenue, until the expenses are actually reimbursed over the five-year period.

UNREIMBURSED PRACTICE-RELATED EXPENSES INCLUDE:

Operating Losses. Newly-developed or *de novo* centers typically generate operating losses during their first 12 months of operations. Under the terms of most of the Company s Service Agreements, the Company generally funds these operating losses and defers reimbursement of the Affiliated Practice s portion of the operating losses until the *de novo* center begins to generate operating profits. The Company records the related operating expenses in its consolidated statements of income when incurred. The Company generally charges the Affiliated Practice interest on those deferred amounts at market rates. After the *de novo* center becomes profitable, the Affiliated Practice usually begins to reimburse the Company for the operating losses over a five-year period. Mature practices may also occasionally generate operating losses, which are generally repaid in subsequent periods from amounts that otherwise would have been retained by the Affiliated Practice.

Depreciation Expense Relating To Property, Equipment and Improvements. The Company generally purchases and provides the property, equipment and improvements used in Affiliated Practices. The Company depreciates property, equipment and improvements over their estimated useful lives and records the depreciation expense in the Company s consolidated statements of income. Under the terms of most of the Company s Service Agreements, Affiliated Practices generally reimburse the Company for their portion of the costs of these property, equipment and improvements over a five-year period. The Company charges the Affiliated Practice interest on these amounts at market rates.

Under the terms of the Company s general form of Service Agreements, the Affiliated Practices pledge their patient fees receivable to the Company as collateral for the Company s service fees. The Company is typically responsible for billing and collection of the patient fees receivable, which are conducted in the name of the applicable Affiliated Practice. Collections are generally deposited into a depository bank account that the Company establishes and maintains. Service fees receivable do not include any service fees receivable relating to certain OrthAlliance affiliated practices that are parties to litigation pending against OrthAlliance and that have ceased remitting service fees to OrthAlliance.

4. LONG-LIVED ASSETS

Intangible Assets:

The Company generally affiliates with an existing orthodontic or pediatric dental practice by entering into a Service Agreement and acquiring substantially all of the non-professional assets of the practice or professional corporation. The acquired assets generally consist of equipment, furniture, fixtures and leasehold interests. The Company records these acquired tangible assets at their fair value as of the date of acquisition and depreciates or amortizes these assets using the straight-line method over their useful lives. The remainder of the purchase price is allocated to an intangible asset, which represents the cost of obtaining the Service Agreement. The Company obtains the exclusive right to provide business operations, financial, marketing and administrative services to the Affiliated Practice during the term of the Service Agreement. The Service Agreements generally provide that the professional corporation or entity is responsible for providing orthodontic or pediatric dental services and for employing all orthodontists or pediatric dentists. The terms of the Service Agreements range from 20 to 40 years, with most ranging from 20 to 25 years. In many cases, the Affiliated Practice has the option to terminate the Service Agreement after a certain length of time as prescribed in the Service Agreement. If the Affiliated Practice terminates its affiliation with the Company, it generally is required to purchase all of the related assets, including the unamortized portion of the intangible assets, at the current book value or sell its interests in the practice to another licensed orthodontist or pediatric dentist.

Subsequent to affiliation, an Affiliated Practice may acquire an existing practice, center or patient base. The Company may pay additional consideration to the Affiliated Practice to amend its Service Agreement

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to extend the Company s affiliation to such newly acquired practice. Such an extension provides the Company with the opportunity to earn additional service fees. The consideration is allocated to an intangible asset.

Components of the Company s intangible assets at March 31, 2003 and December 31, 2002 were as follows:

	March 31, 2003	December 31, 2002
	(in thousands)	
Cost of intangible assets	$260,893	$262,411
Less accumulated amortization	42,623	42,028
Intangible assets, net	$218,270	$220,383

Intangible assets are amortized on a straight-line basis over the shorter of the term of the related Service Agreement or 25 years. Amortization expense relating to intangible assets was $2.4 million and $2.6 million for the three months ended March 31, 2003 and 2002, respectively. Intangible assets and the related accumulated amortization are written off when fully amortized.

Property, Equipment and Improvements:

Property, equipment and improvements consisted of the following:

	March 31, 2003	December 31, 2002
	(in thousands)	
Leasehold improvements	$ 75,725	$ 73,703
Furniture and fixtures	66,694	64,990
Other equipment	209	209
Centers in progress	256	490
	142,884	139,392
Less accumulated depreciation and amortization	52,408	49,332
Property, equipment and improvements, net	$ 90,476	$ 90,060

Depreciation expense on property, equipment and improvements was $3.5 million and $2.8 million for the three months ended March 31, 2003 and 2002, respectively.

Impairment of Long-Lived Assets:

The Company assesses long-lived assets for impairment under Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. During the three months ended March 31, 2003, the Company recorded impairments of approximately $302,000 related to intangible assets and approximately $401,000 related to property, equipment and improvements for offices closed during the three months ended March 31, 2003. These amounts are included in Amortization and Depreciation, respectively, in the accompanying Consolidated Statements of Income.

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Goodwill:

Goodwill represents the excess of purchase price over fair value of net assets acquired or arising from a business combination. Goodwill relates to the acquisition of OrthAlliance. The Company assesses goodwill for impairment in accordance with SFAS No. 142, Goodwill and Other Intangible Assets, by measuring the reporting unit at fair value. The Company determined that goodwill was not impaired at March 31, 2003.

5. TRANSACTIONS WITH AFFILIATED PRACTICES

Net advances to Affiliated Practices totaled $30.4&