

RENAL CARE GROUP INC

Form 10-Q

November 02, 2005

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

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended September 30, 2005
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. 0-27640
RENAL CARE GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware **62-1622383**
(State or other jurisdiction of (I.R.S. Employer Identification No.)
incorporation or organization)
2525 West End Avenue, Suite 600, Nashville, Tennessee 37203
(Address of principal executive offices) (Zip code)
Registrant's telephone number, including area code: (615) 345-5500

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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date.

Class	Outstanding at October 31, 2005
Common Stock, \$.01 par value	68,329,507

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Note: Items 2, 3 and 5 of Part II are omitted because they are not applicable

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RENAL CARE GROUP, INC.
Condensed Consolidated Balance Sheets
(in thousands, except per share data)

	December 31, 2004	September 30, 2005 (unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 17,931	\$ 25,490
Accounts receivable, net	275,373	286,773
Inventories	23,359	33,953
Prepaid expenses and other current assets	26,817	34,020
Deferred income taxes	29,604	36,387
Total current assets	373,084	416,623
Property, plant and equipment, net	316,532	354,910
Intangible assets, net	34,320	37,942
Goodwill	694,264	824,022
Other assets	10,780	8,331
Total assets	\$ 1,428,980	\$ 1,641,828
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	\$ 139,929	\$ 151,368
Due to third-party payors	80,007	62,535
Current portion of long-term debt	23,969	36,597
Total current liabilities	243,905	250,500
Long-term debt, net of current portion	479,645	566,696
Deferred income taxes	51,419	51,046
Other long-term liabilities	16,271	15,495
Minority interest	45,619	57,406
Total liabilities	836,859	941,143
Commitments and contingencies		
Stockholders equity:		
Preferred stock, \$0.01 par value, 10,000 shares authorized, none issued		
Common stock, \$0.01 par value, 150,000 shares authorized, 82,317 and 83,100 shares issued at December 31, 2004 and September 30, 2005, respectively	823	831
Treasury stock, 14,514 and 14,766 shares of common stock at December 31, 2004 and September 30, 2005, respectively	(372,249)	(381,635)
Additional paid-in capital	411,888	431,278

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Retained earnings	551,863	648,943
Accumulated other comprehensive (loss) income, net of tax	(204)	1,268
Total stockholders' equity	592,121	700,685
Total liabilities and stockholders' equity	\$ 1,428,980	\$ 1,641,828

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
Condensed Consolidated Income Statements
(in thousands, except per share data)
(unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2004	2005	2004	2005
Net revenue	\$ 356,111	\$ 402,230	\$ 974,993	\$ 1,160,068
Operating costs and expenses:				
Patient care costs	239,400	267,889	648,621	769,322
General and administrative expenses	26,336	34,275	76,353	100,967
Provision for doubtful accounts	8,464	5,396	23,623	22,546
Depreciation and amortization	15,344	18,173	42,407	52,735
Total operating costs and expenses	289,544	325,733	791,004	945,570
Income from operations	66,567	76,497	183,989	214,498
Interest expense, net	6,869	8,715	13,599	23,957
Income before minority interest and income taxes	59,698	67,782	170,390	190,541
Minority interest	10,158	9,915	25,062	28,409
Income before income taxes	49,540	57,867	145,328	162,132
Provision for income taxes	19,072	22,636	55,590	65,052
Net income	\$ 30,468	\$ 35,231	\$ 89,738	\$ 97,080
Net income per share:				
Basic	\$ 0.45	\$ 0.52	\$ 1.33	\$ 1.43
Diluted	\$ 0.44	\$ 0.50	\$ 1.28	\$ 1.37
Weighted average shares outstanding:				
Basic	67,095	68,167	67,612	68,022
Diluted	69,339	71,023	69,930	70,721

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Nine Months Ended September 30,	
	2004	2005
OPERATING ACTIVITIES		
Net income	\$ 89,738	\$ 97,080
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	42,407	52,735
Loss on sale of property and equipment	624	661
Distributions to minority shareholders	(11,409)	(15,807)
Income applicable to minority interest	25,062	28,409
Deferred income taxes	10,734	2,207
Changes in operating assets and liabilities, net of effects from acquisitions	(21,062)	(28,506)
Net cash provided by operating activities	136,094	136,779
INVESTING ACTIVITIES		
Purchases of property and equipment	(66,463)	(67,507)
Cash paid for acquisitions, net of cash acquired	(274,644)	(167,766)
Change in other assets	(7,185)	3,062
Net cash used in investing activities	(348,292)	(232,211)
FINANCING ACTIVITIES		
Net proceeds from issuance of long-term debt	325,000	100,000
Payments on long-term debt	(8,125)	(16,251)
Net borrowings under line of credit and capital leases	7,027	15,930
Net proceeds from issuance of common stock	17,799	12,698
Repurchase of treasury shares	(137,845)	(9,386)
Net cash provided by financing activities	203,856	102,991
(Decrease) increase in cash and cash equivalents	(8,342)	7,559
Cash and cash equivalents at beginning of period	50,295	17,931
Cash and cash equivalents at end of period	\$ 41,953	\$ 25,490

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005

(dollars in thousands, except per share data)
(unaudited)

1. Basis of Presentation

Overview

Renal Care Group, Inc. provides dialysis services to patients with chronic kidney failure, also known as end-stage renal disease. As of September 30, 2005, we provided dialysis and ancillary services to over 32,000 patients through more than 450 owned outpatient dialysis centers in 34 states, in addition to providing acute dialysis services at more than 200 hospitals.

Renal Care Group's net revenue has been derived primarily from the following sources:
outpatient hemodialysis services;

ancillary services associated with dialysis, primarily the administration of Epogen® (erythropoietin alfa, to which we refer as EPO);

home dialysis services;

inpatient hemodialysis services provided to acute care hospitals and skilled nursing facilities;

laboratory services; and

management contracts with hospital-based and medical university dialysis programs.

Most patients with end-stage renal disease receive three dialysis treatments each week in an outpatient setting. Reimbursement for these services is provided primarily by the Medicare ESRD program based on rates established by the Centers for Medicare and Medicaid Services (CMS). For the nine months ended September 30, 2005 and 2004, approximately 57% and 53%, respectively, of our net revenue was derived from reimbursement under the Medicare and Medicaid programs. Medicare reimbursement is subject to rate and other legislative changes by Congress and to periodic changes in regulations, including changes that may reduce payments under the ESRD program. Neither Congress nor CMS approved an increase in the composite rate for 2004. Congress approved an increase of 1.6% in the Medicare ESRD composite rate for 2005, as well as changes in the way we are paid for separately billable drugs.

The Medicare composite rate applies to a designated group of outpatient dialysis services, including the dialysis treatment, supplies used for the treatment, certain laboratory tests and medications, and most of the home dialysis services we provide. Renal Care Group receives separate reimbursement outside the composite rate for some other services, drugs, including specific drugs such as EPO, and some physician-ordered tests, including laboratory tests, provided to dialysis patients.

Congress mandated a change in the way we are paid beginning in 2005 for most of the drugs, including EPO, that we bill for outside of the flat composite rate. This change resulted in lower reimbursement for these drugs and a higher composite rate. In 2005 we are reimbursed for the top ten separately billable ESRD drugs at average acquisition cost, and we are reimbursed for other separately billable ESRD drugs at average sales price plus 6.0%. In addition, the composite rate was increased by 8.7% for 2005. These regulations also include a case-mix adjustment that became effective in April 2005, a geographic adjustment to the composite rate and a budget-neutrality adjustment. Management believes these changes coupled with the 1.6% increase in the Medicare composite rate in 2005 have been slightly positive to Renal Care Group's revenue per treatment and earnings in 2005.

On August 1, 2005, CMS issued its proposed rules that would revise payment for separately billable drugs and biologicals. Under the proposal, the payment rate will be set at average sales price plus 6.0% for all separately billable ESRD drugs. CMS has also proposed to change the drug add-on adjustment that took effect January 1, 2005, and to update the geographic designations and wage index for the composite rate. CMS has indicated that the government's

intent is to achieve revenue neutrality; however, management believes that the proposed rules could result in a reduction in reimbursement.

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If a patient is younger than 65 years old and has private health insurance, then that patient's treatment is typically reimbursed at rates significantly higher than Medicare during the first 30 months of care. After that period, Medicare becomes the primary payor. Reimbursement for dialysis services provided pursuant to a hospital contract is negotiated with the individual hospital and is usually higher than the Medicare composite rate. Because dialysis is a life-sustaining therapy to treat a chronic disease, utilization is predictable and is not subject to seasonal fluctuations.

We derive a significant portion of our revenue and earnings from the administration of EPO. EPO is manufactured by a single company, Amgen, Inc. EPO is used to treat anemia, a medical complication frequently experienced by dialysis patients. Changes in our contract with Amgen for 2005 along with changes in Amgen's packaging practices for EPO has resulted in a slight increase in our cost of EPO in 2005. Net revenue from the administration of EPO was 24% and 27% of our net revenue for the nine months ended September 30, 2005 and 2004, respectively.

Change in Accounting Estimate

During the three months ended September 30, 2005 we obtained final determination of certain Medicare cost report settlements. Accordingly, during this period we recognized a change in estimate of \$2,611 (net of related tax expense of \$1,676), or \$0.04 per share, resulting in a reduction to the provision for doubtful accounts.

Interim Financial Statements

Management believes the information contained in this quarterly report on Form 10-Q reflects all adjustments necessary to make the results of operations for the interim periods a fair representation of such operations. All such adjustments are of a normal recurring nature. Operating results for interim periods are not necessarily indicative of results that may be expected for the year as a whole. We suggest that you read these financial statements in conjunction with our consolidated financial statements and the related notes thereto included in our annual report on Form 10-K for the year ended December 31, 2004, as filed with the SEC on March 2, 2005.

Reclassifications

Certain prior year balances have been reclassified to conform to the current year presentation. These reclassifications had no effect on the results of operations as previously reported.

2. Acquisition by Fresenius Medical Care AG

On May 3, 2005 we entered into a definitive merger agreement with Fresenius Medical Care AG in which Fresenius Medical Care agreed to acquire all of Renal Care Group's outstanding stock. Fresenius Medical Care will pay \$48.00 for each of our outstanding shares of common stock. Fresenius Medical Care will acquire Renal Care Group subject to its outstanding indebtedness, which was approximately \$603.3 million as of September 30, 2005. In connection with the Fresenius Medical Care transaction, we incurred general and administrative expenses of approximately \$10,350 pre-tax in the nine-month period ended September 30, 2005.

Our Board of Directors and the management and supervisory boards of Fresenius Medical Care have approved the transaction, and on August 24, 2005 our stockholders voted to approve the transaction. Completion of the transaction is subject to customary conditions to closing, including the termination or expiration of the waiting period under the Hart-Scott Rodino Antitrust Improvements Act of 1976, as amended. In June 2005, we received a request for additional information under the Hart-Scott Rodino Act from the Federal Trade Commission. We are providing information to the Federal Trade Commission to respond to this request. The Fresenius Medical Care transaction may not be completed before 30 days after certification by us and Fresenius Medical Care of substantial compliance with the Federal Trade Commission's request for additional information or until earlier satisfaction by the Federal Trade Commission that the transactions will not raise anticompetitive concerns. Management believes the transaction will close in the fourth quarter of 2005 or early in 2006.

On May 11, 2005, Renal Care Group was served with a complaint in the Chancery Court for the State of Tennessee Twentieth Judicial District at Nashville styled *Plumbers Local #65 Pension Fund, on behalf of itself and all others similarly situated, Plaintiff, vs. Renal Care Group, Inc., William P. Johnston, Gary Brukardt, Peter J. Grua, Joseph C. Hutts, Harry R. Jacobson, William V. Lapham, Thomas A. Lowery, Stephen D. McMurray and C. Thomas Smith, Defendants*. On May 26, 2005, Renal Care Group was served with a complaint in the Chancery Court for the State of Tennessee Twentieth Judicial District at Nashville styled *Hawaii Structural Ironworkers Pension Trust Fund, on behalf of itself and all others similarly situated, Plaintiff, vs. Renal Care Group, Inc., William P. Johnston, Gary Brukardt, Peter J. Grua, Joseph C. Hutts, Harry R. Jacobson, William V. Lapham, Thomas A. Lowery, Stephen D.*

McMurray and C. Thomas Smith, Defendants. On May 31, 2005, Renal Care Group was served with a complaint in the

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Chancery Court for the State of Tennessee Twentieth Judicial District at Nashville styled *Indiana State District Council of Laborers and Hod Carriers Pension Fund, on behalf of itself and others similar situated, Plaintiff, vs. Renal Care Group, Inc., William P. Johnston, Gary Brukart, Peter J. Grua, Joseph C. Hutts, Harry R. Jacobson, William V. Lapham, Thomas A. Lowery, Stephen D. McMurray and C. Thomas Smith, Defendants*. The original complaints in these three lawsuits were substantially identical. Each complaint was brought by the plaintiff shareholder as a purported class action on behalf of all shareholders similarly situated. The complaints allege that Renal Care Group and its directors engaged in self-dealing and breached their fiduciary duties to Renal Care Group's shareholders in connection with the merger agreement between Renal Care Group and Fresenius Medical Care because, among other things, Renal Care Group used a flawed process, the existence of the previously disclosed subpoena from the Department of Justice, the lack of independence of one of Renal Care Group's financial advisors and the existence of Renal Care Group's supplemental executive retirement plan. Renal Care Group removed these cases to federal court in June 2005.

The plaintiffs in the first two cases dismissed them without prejudice in July 2005, and the third plaintiff filed an amended complaint. The amended complaint asserts the same grounds articulated in the original complaint adding more specific allegations regarding the termination fee, the non-solicitation clause and the matching rights provision in the Merger Agreement, and it adds allegations that our proxy statement makes material misrepresentations and omissions regarding the process by which the merger agreement was negotiated. Specifically, the amended complaint asserts that the proxy statement makes material misstatements or omissions regarding: (1) the reason Renal Care Group's management and board engaged in a closed process of negotiating a potential merger with Fresenius and did not solicit potential competing bids from alternative purchasers; (2) the reason Renal Care Group's board did not appoint a special committee to evaluate the fairness of the merger; (3) the alternatives available to Renal Care Group including potential alternative transactions and other strategic business opportunities, which purportedly were considered by Renal Care Group's board during the strategic planning process the board engaged in during the second half of 2004; (4) all information regarding conflicts of interest suffered by defendants and their financial and legal advisors as alleged herein; (5) all information regarding past investment banking services Bank of America has performed for Renal Care Group and Fresenius and the compensation Bank of America received for those services; (6) the forecasts and projections prepared by Renal Care Group's management for fiscal years 2005 through 2008 that were referenced in the fairness opinions by Morgan Stanley; (7) the estimates of transaction synergies provided by Renal Care Group's management that were referenced in the fairness opinions by Morgan Stanley; and (8) information concerning the amount of money Bank of America and Morgan Stanley will receive in connection with the proposed merger. Renal Care Group believes that the allegations in the pending complaint are without merit. Completion of the merger is subject to customary conditions, including the absence of any order or injunction prohibiting the closing. The pending complaint seeks to enjoin and prevent the parties from completing the Fresenius Medical Care transaction. The pending complaint was remanded to Tennessee state court in September 2005.

3. Business Acquisitions**2005 Acquisitions**

During the first nine months of 2005, we completed a number of acquisitions and purchased the minority partners ownership interests in some of our existing joint ventures. The combined net assets acquired and resulting net cash purchase price paid in these transactions were \$167,766. Each of the transactions (other than the purchases of minority partners' interests in existing joint ventures) involved the acquisition of the net assets of entities that provide care to ESRD patients through owned dialysis facilities. The acquired businesses either strengthened our existing market share within a specific geographic area or provided us with an entrance into one or more new markets. We began recording the results of operations for each of the acquired businesses at the effective dates of the respective transactions.

The following table summarizes the preliminarily estimated fair values of the assets acquired and liabilities assumed at the date of acquisition for the transactions completed during the first nine months of 2005:

Accounts receivable, net	\$ 1,122
Inventory and other current assets	982

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Property, plant and equipment, net	20,067
Intangible assets	7,140
Goodwill	138,873
Total assets acquired	168,184
Total liabilities assumed	418
Net assets acquired	\$ 167,766

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Some of the estimated fair values of assets and liabilities are preliminary and may be adjusted. Items that may be adjusted include items such as deferred tax assets and liabilities, and the valuation of certain assets. Intangible assets primarily represent the value assigned to contracts such as non-competition agreements entered into in the transactions. Related amounts will be amortized over the lives of the contracts, which generally range from five to twelve years.

Pro Forma Data

The following summary, prepared on a pro forma basis, combines our results of operations with those of the businesses we acquired in 2005. These pro forma results reflect the combined results of Renal Care Group and the acquired businesses as if the acquisitions had been consummated as of the beginning of the period presented, giving effect to adjustments such as amortization of intangibles, interest expense and related income taxes.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Pro forma net revenue	\$ 372,291	\$ 403,572	\$ 1,023,534	\$ 1,182,198
Pro forma net income	\$ 32,704	\$ 35,692	\$ 96,472	\$ 100,626
Pro forma net income per share:				
Basic	\$ 0.49	\$ 0.52	\$ 1.43	\$ 1.48
Diluted	\$ 0.47	\$ 0.50	\$ 1.38	\$ 1.42

The unaudited pro forma results of operations are not necessarily indicative of what actually would have occurred if the acquisitions had been completed prior to the beginning of the periods presented.

Joint Ventures

During the quarter ended September 30, 2005, we purchased minority ownership interests in seven existing joint ventures for approximately \$20,900. These purchases reduced the number of joint ventures in which we were the majority and controlling owner to 68 at September 30, 2005.

4. Long-Term Debt

Long-term debt consisted of the following as of December 31, 2004 and September 30, 2005:

	December 31, 2004	September 30, 2005
Term loan facility, bearing interest at a variable rate (5.3% at September 30, 2005)	\$ 312,813	\$ 296,563
Incremental term loan, bearing interest at a variable rate (5.1% at September 30, 2005)		100,000
9% senior subordinated notes	159,685	159,685
Obligations under capital leases	4,151	4,984
Other, including amounts outstanding under the revolving credit facility	3,357	20,541
Total indebtedness, excluding fair value premium	480,006	581,773
Add: 9% senior subordinated notes fair value premium	23,608	21,520
Total long-term debt	503,614	603,293
Less: current portion	23,969	36,597

\$ 479,645 \$ 566,696

Credit Agreements

We are a party to a credit agreement (the 2004 Agreement) with a group of banks totaling up to \$700,000. The 2004 agreement has a \$150,000 revolving credit facility, a \$325,000 term loan facility and a \$225,000 incremental term loan facility. In May 2005, we completed an incremental term loan of \$100,000 under the 2004 Agreement. We used the proceeds of this incremental term loan to finance some of our 2005 acquisitions. The revolving credit facility, the \$325,000 term loan facility, and the \$100,000 incremental

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term loan facility have a final maturity of February 10, 2009. Each of our wholly-owned subsidiaries has guaranteed all of our obligations under the 2004 Agreement. Further, our obligations under the 2004 Agreement, and our subsidiaries' obligations under their guarantees, are secured by a pledge of the equity interests we hold in each of our subsidiaries. The 2004 Agreement includes financial covenants that are customary based on the amount and duration of the agreement.

The revolving credit facility under the 2004 Agreement may be used for acquisitions, repurchases of Company common stock, capital expenditures, working capital and general corporate purposes. All borrowings under the 2004 Agreement accrue interest at variable rates determined by the Company's leverage ratio. Effective June 30, 2004, we entered into interest rate swap agreements to hedge interest rate risk on \$150,000 of our term loan (See Interest Rate Swap below). The portion of our borrowings that is subject to variable rates carries a degree of interest rate risk. Specifically, the Company will face higher interest costs on this debt if interest rates rise.

9% Senior Subordinated Notes

With our acquisition of National Nephrology Associates, Inc. in April 2004, we assumed all of NNA's outstanding debt including its 9% senior subordinated notes due 2011. We recorded the senior subordinated notes at the face value of \$160,000 plus an additional \$25,600 representing the difference between the fair value of the senior subordinated notes and the face amount on the date of acquisition. Accordingly, the senior subordinated notes were recorded at the estimated fair value of \$185,600. As of September 30, 2005, the carrying value of the senior subordinated notes was \$181,205.

The senior subordinated notes bear interest at the rate of 9% per annum on the face amount. The fair value premium is being recognized over the life of the senior subordinated notes using the effective interest method and is recorded as a reduction to interest expense. Accordingly, the effective interest rate on the senior subordinated notes as of September 30, 2005 was 6.4%. Each of our wholly-owned subsidiaries has guaranteed all of our obligations under these senior subordinated notes. The rights of the noteholders and our obligations under these senior subordinated notes are set forth in an indenture that NNA entered into in October 2003, which we assumed in connection with the NNA acquisition. The indenture includes customary financial covenants.

Interest Rate Swap

Effective June 30, 2004, we entered into interest rate swap agreements to hedge the interest rate risk on \$150,000 of our term loan. Under these interest rate swap agreements we will exchange fixed and variable rate interest payments based on a \$150,000 notional principal amount through March 30, 2007. The notional amount of \$150,000 and interest payments of 3.5% are fixed in the agreements. We expect changes in cash flows under these agreements to offset the changes in interest rate payments attributable to fluctuations in LIBOR. The hedge is structured to qualify for the shortcut method as prescribed by Statement of Financial Accounting Standard (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*; therefore, we record changes in the fair value of the agreement directly in other comprehensive income. As of September 30, 2005, the notional amount of the swap agreements was \$150,000 and their fair value was \$2,065, resulting in an unrealized gain of \$1,472 during the nine month period ended September 30, 2005 (net of a related tax expense of \$925).

Obligations Under Capital Leases

Obligations under capital leases consist primarily of capital leases for buildings and equipment maturing at various times through August 2019.

Other

The other long-term debt consists primarily of notes and amounts outstanding under the revolving credit facility, maturing at various times through February 2009.

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Maturities of Long-Term Debt

The aggregate maturities of long-term debt, excluding the fair value premium, at September 30, 2005 are as follows:

2005	\$ 7,443
2006	42,273
2007	79,854
2008	208,068
2009	82,143
Thereafter	161,992
	\$ 581,773

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Our wholly-owned subsidiaries have guaranteed the 9% subordinated notes as well as our obligations under the 2004 Agreement. We conduct substantially all of our business through subsidiaries. Presented below is condensed consolidating financial information as of September 30, 2005 and December 31, 2004 and for the three months and nine months ended September 30, 2005 and 2004, respectively. The information segregates Renal Care Group, Inc. (the parent company), the combined wholly-owned subsidiary guarantors and the combined non-guarantor subsidiaries and reflects consolidating adjustments. All of the subsidiary guarantees are both full and unconditional, and joint and several.

Condensed Consolidating Balance Sheets

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
As of December 31, 2004					
Cash and cash equivalents	\$	\$	\$ 31,945	\$ (14,014)	\$ 17,931
Accounts receivable, net		198,778	76,595		275,373
Other current assets	45,749	23,320	10,711		79,780
Total current assets	45,749	222,098	119,251	(14,014)	373,084
Property, plant and equipment, net	29,542	189,434	96,408	1,148	316,532
Goodwill	1,483	574,815	117,666	300	694,264
Other assets	10,828	99,033	7,436	(72,197)	45,100
Total assets	\$ 87,602	\$ 1,085,380	\$ 340,761	\$ (84,763)	\$ 1,428,980
Current liabilities (including intercompany assets and liabilities)	\$ (699,042)	\$ 813,091	\$ 157,344	\$ (27,488)	\$ 243,905
Long-term debt	476,184	(259)	3,720		479,645
Long-term liabilities	64,976	2,253	461		67,690
Minority interest		39,610	5,989	20	45,619
Stockholders equity	245,484	230,685	173,247	(57,295)	592,121
Total liabilities and stockholders equity	\$ 87,602	\$ 1,085,380	\$ 340,761	\$ (84,763)	\$ 1,428,980
As of September 30, 2005					
Cash and cash equivalents	\$	\$	\$ 34,615	\$ (9,125)	\$ 25,490
Accounts receivable, net		212,032	74,741		286,773
Other current assets	55,756	32,919	15,685		104,360
Total current assets	55,756	244,951	125,041	(9,125)	416,623
Property, plant and equipment, net	36,771	222,178	94,833	1,128	354,910
Goodwill	1,483	699,929	122,310	300	824,022
Other assets	9,165	105,419	6,748	(75,059)	46,273

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Total assets	\$ 103,175	\$ 1,272,477	\$ 348,932	\$ (82,756)	\$ 1,641,828
Current liabilities (including intercompany assets and liabilities)	\$ (731,456)	\$ 890,292	\$ 125,546	\$ (33,882)	\$ 250,500
Long-term debt	561,830	193	4,673		566,696
Long-term liabilities	58,700	6,211	1,630		66,541
Minority interest		48,029	9,428	(51)	57,406
Stockholders equity	214,101	327,752	207,655	(48,823)	700,685
Total liabilities and stockholders equity	\$ 103,175	\$ 1,272,477	\$ 348,932	\$ (82,756)	\$ 1,641,828

Table of Contents**Condensed Consolidating Income Statements**

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the three months ended September 30, 2004					
Net revenue	\$ 1,718	\$ 245,757	\$ 110,181	\$ (1,545)	\$ 356,111
Total operating costs and expenses	12,402	198,053	80,634	(1,545)	289,544
Income (loss) from operations	(10,684)	47,704	29,547		66,567
Interest expense (income), net	6,850	(92)	111		6,869
Minority interest		9,300	858		10,158
Provision (benefit) for income taxes	(6,750)	14,821	11,001		19,072
Net income (loss)	\$ (10,784)	\$ 23,675	\$ 17,577	\$	\$ 30,468

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the three months ended September 30, 2005					
Net revenue	\$ 916	\$ 291,743	\$ 111,218	\$ (1,647)	\$ 402,230
Total operating costs and expenses	18,216	224,727	84,437	(1,647)	325,733
Income (loss) from operations	(17,300)	67,016	26,781		76,497
Interest expense (income), net	8,669	(117)	163		8,715
Minority interest		9,164	751		9,915
Provision (benefit) for income taxes	(9,234)	22,051	9,819		22,636
Net income (loss)	\$ (16,735)	\$ 35,918	\$ 16,048	\$	\$ 35,231

Table of Contents**Condensed Consolidating Income Statements**

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the nine months ended September 30, 2004					
Net revenue	\$ 2,652	\$ 674,627	\$ 301,690	\$ (3,976)	\$ 974,993
Total operating costs and expenses	38,553	527,544	228,883	(3,976)	791,004
Income (loss) from operations	(35,901)	147,083	72,807		183,989
Interest expense (income), net	13,580	(92)	111		13,599
Minority interest		23,320	1,742		25,062
Provision (benefit) for income taxes	(18,942)	47,371	27,161		55,590
Net income (loss)	\$ (30,539)	\$ 76,484	\$ 43,793	\$	\$ 89,738

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the nine months ended September 30, 2005					
Net revenue	\$ 2,327	\$ 818,092	\$ 344,788	\$ (5,139)	\$ 1,160,068
Total operating costs and expenses	55,101	635,114	260,494	(5,139)	945,570
Income (loss) from operations	(52,774)	182,978	84,294		214,498
Interest expense (income), net	23,992	(455)	420		23,957
Minority interest		25,985	2,424		28,409
Provision (benefit) for income taxes	(26,565)	60,381	31,236		65,052
Net income (loss)	\$ (50,201)	\$ 97,067	\$ 50,214	\$	\$ 97,080

Table of Contents**Condensed Consolidating Statements of Cash Flows**

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the nine months ended September 30, 2004					
Cash flows from operating activities:					
Net income (loss)	\$ (30,539)	\$ 76,484	\$ 43,793	\$	\$ 89,738
Changes in operating and intercompany assets and liabilities and non-cash items included in net income	(87,188)	74,728	26,476	32,340	46,356
Net cash provided by (used in) operating activities	(117,727)	151,212	70,269	32,340	136,094
Net cash (used in) provided by investing activities	(167,259)	(153,167)	(30,233)	2,367	(348,292)
Net cash provided by (used in) financing activities	264,829	(691)	(12,415)	(47,867)	203,856
(Decrease) increase in cash and cash equivalents	(20,157)	(2,646)	27,621	(13,160)	(8,342)
Cash and cash equivalents, at beginning of period	20,157	2,646	27,492		50,295
Cash and cash equivalents, at end of period	\$	\$	\$ 55,113	\$ (13,160)	\$ 41,953
	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the nine months ended September 30, 2005					
Cash flows from operating activities:					
Net income (loss)	\$ (50,201)	\$ 97,067	\$ 50,214	\$	\$ 97,080
Changes in operating and intercompany assets and liabilities and non-cash items included in net income	(30,842)	93,255	(19,111)	(3,603)	39,699
Net cash provided by (used in) operating activities	(81,043)	190,322	31,103	(3,603)	136,779
Net cash (used in) provided by investing activities	(27,877)	(190,774)	(13,580)	20	(232,211)
Net cash provided by (used in) financing activities	108,920	452	(14,853)	8,472	102,991

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Increase in cash and cash equivalents			2,670		4,889		7,559
Cash and cash equivalents, at beginning of period			31,945		(14,014)		17,931
Cash and cash equivalents, at end of period	\$	\$	\$ 34,615	\$	(9,125)	\$	25,490

Table of Contents**5. Net Income per Share**

The following table sets forth the computation of basic and diluted net income per share (shares in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2004	2005	2004	2005
Numerator:				
Numerator for basic and diluted net income per share net income	\$ 30,468	\$ 35,231	\$ 89,738	\$ 97,080
Denominator:				
Denominator for basic net income per share weighted-average shares	67,095	68,167	67,612	68,022
Effect of dilutive securities:				
Stock options	2,244	2,856	2,318	2,699
Denominator for diluted net income per share adjusted weighted-average shares and assumed conversions	69,339	71,023	69,930	70,721
Net income per share:				
Basic	\$ 0.45	\$ 0.52	\$ 1.33	\$ 1.43
Diluted	\$ 0.44	\$ 0.50	\$ 1.28	\$ 1.37

6. Stockholders Equity*Stock-based Compensation*

We account for stock-based compensation to employees and directors using the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. Accordingly, we recognize no compensation expense when we grant fixed options to employees and directors, because the exercise price of the stock options equals or exceeds the market price of the underlying stock on the dates of grant. Option grants to medical directors and non-vested stock grants are expensed over their vesting periods.

All outstanding stock options and all of the outstanding nonvested stock awards became fully vested on August 24, 2005, as a result of the stockholders' vote to approve Fresenius Medical Care's acquisition of Renal Care Group, which represented a change of control under the applicable provisions of the Company's stock-based compensation plans. The information set forth below reflects the estimated pro forma after-tax charge the Company would have incurred during the third quarter of 2005 as a result of the accelerated vesting of stock options.

The following table presents the pro forma effect on net income and net income per share as if we had applied the fair value based method and recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, (SFAS No. 123) to stock-based compensation to employees and directors:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Net income, as reported	\$ 30,468	\$ 35,231	\$ 89,738	\$ 97,080
Add: stock-based compensation expense, net of related tax effects, included in the determination of net income as reported	131	319	188	431
Less: stock-based compensation expense, net of related tax effects, determined by the fair value-based method	(2,889)	(18,474)	(7,431)	(23,236)

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Pro forma net income	\$ 27,710	\$ 17,076	\$ 82,495	\$ 74,275
Net income per share:				
Basic, as reported	\$ 0.45	\$ 0.52	\$ 1.33	\$ 1.43
Basic, pro forma	\$ 0.41	\$ 0.25	\$ 1.22	\$ 1.09
Diluted, as reported	\$ 0.44	\$ 0.50	\$ 1.28	\$ 1.37
Diluted, pro forma	\$ 0.40	\$ 0.24	\$ 1.18	\$ 1.05

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The effects of applying SFAS No. 123 for providing pro forma disclosures are not likely to be representative of the effects on reported net income for future periods.

Stock Split

On April 27, 2004, we announced a three-for-two stock split in the form of a stock dividend distributed to shareholders of record as of May 7, 2004. On May 24, 2004 we issued one share for every two shares held by shareholders as of the record date. The par value of our common stock remained unchanged at \$0.01.

Authorized Shares

On June 9, 2004, our shareholders approved an amendment to the certificate of incorporation increasing the number of authorized shares of common stock from 90,000 to 150,000.

7. Contingencies

On October 25, 2004, we received a subpoena from the office of the United States Attorney for the Eastern District of New York. The subpoena requires the production of documents related to numerous aspects of our business and operations, including those of RenaLab, Inc., our laboratory. The subpoena includes specific requests for documents related to testing for parathyroid hormone (PTH) levels and vitamin D therapies. To our knowledge, no proceedings have been initiated against Renal Care Group at this time, although we cannot predict whether or when proceedings might be initiated. We intend to cooperate with the government's investigation. Compliance with the subpoena will require us to incur substantial legal expenses and will require management attention. We cannot predict whether legal proceedings will be initiated against us in connection with this investigation or, if initiated, the outcome of any proceedings.

On August 9, 2005, we received a subpoena from the office of the United States Attorney for the Eastern District of Missouri. The subpoena requires the production of documents related to numerous aspects of our business and operations. The subpoena includes specific requests for documents related to our supply company, pharmaceutical and other services we provide to patients, our relationships with pharmaceutical companies, our relationships with physicians, medical director compensation, joint ventures with physicians and our purchases of dialysis equipment from Fresenius Medical Care. The subpoena was issued in connection with a joint civil and criminal investigation. To our knowledge, no proceedings have been initiated against Renal Care Group at this time, although we cannot predict whether or when proceedings might be initiated. We intend to cooperate with the government's investigation. Compliance with the subpoena will require us to incur substantial legal expenses and will require management attention. We cannot predict whether any legal proceedings will be initiated against us in connection with this investigation or, if initiated, the outcome of any proceedings.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. We believe that we are in compliance with all applicable laws and regulations governing the Medicare and Medicaid programs. We are not aware of any other pending or threatened investigations involving allegations of potential noncompliance with applicable laws or regulations. While no regulatory inquiries other than those described above have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

We are involved in other litigation and regulatory investigations arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, these matters will be resolved without material adverse effect on our consolidated financial position or results of operations.

8. Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)), which is a revision of SFAS No. 123. SFAS No. 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. On April 14, 2005, the United States Securities and Exchange Commission announced it would permit most registrants subject to its oversight, including Renal Care Group, additional time to implement the requirements in SFAS No.

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123(R). As announced, the SEC will permit companies to implement SFAS No. 123(R) at the beginning of their next fiscal year (instead of their next reporting period) that begins after June 15, 2005. We are evaluating the requirements of SFAS No. 123(R). We expect that the adoption of SFAS No. 123(R), effective January 1, 2006, will have an impact on our consolidated results of operations and earnings per share. We have not yet determined the method of adoption or the potential financial impact of adopting SFAS No. 123(R).

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**Results of Operations****Three Months Ended September 30, 2004 Compared to Three Months Ended September 30, 2005**

Net Revenue. Net revenue increased from \$356.1 million for the three months ended September 30, 2004 to \$402.2 million for the three months ended September 30, 2005, an increase of \$46.1 million, or 13.0%. This increase resulted primarily from a 10.5% increase in the number of treatments we performed from 1,125,021 in the 2004 period to 1,243,131 in the 2005 period. This growth in treatments is the result of acquisitions we completed after October 1, 2004 along with a 3.3% increase in same-market treatments for the 2005 period compared to the 2004 period. In addition, average patient revenue per treatment increased 2.5% from \$314 in 2004 to \$322 in 2005. The increase was largely due to the impact of price increases to our commercial payors and benefits from renegotiating certain managed care contracts. In addition, revenue per treatment increased modestly as a result of the net impact of Medicare's 1.6% composite rate increase and changes in its reimbursement for separately billable drugs, along with the case mix adjustment that became effective in April 2005, all of which resulted from the Medicare Modernization Act. These favorable effects on our revenue per treatment were partially offset by increases in the percentage of total net revenue that was derived from reimbursement under the Medicare and Medicaid programs, as well as decreases in the utilization of certain drugs, primarily EPO.

Patient Care Costs. Patient care costs consist of costs directly related to the care of patients, including direct labor, drugs and other medical supplies, and operational costs of facilities. Patient care costs increased from \$239.4 million for the three months ended September 30, 2004, to \$267.9 million for the three months ended September 30, 2005, an increase of 11.9%. This increase was due principally to the increase in the number of treatments we performed during the period, which resulted in corresponding increases in the use of labor, drugs and supplies. Patient care costs as a percentage of revenue decreased from 67.2% in the 2004 period to 66.6% in the 2005 period. Patient care costs per treatment increased from \$213 in the 2004 period to \$215 in the 2005 period primarily as a result of higher labor, benefit and insurance costs. During the third quarter of 2005, we experienced increases in the cost of some of our insurance programs, primarily medical malpractice and workers compensation. Management believes that these costs along with salary and benefit costs will continue to increase through the remainder of 2005.

General and Administrative Expenses. General and administrative expenses include corporate office costs and other costs not directly related to the care of patients, including facility administration, accounting, billing, legal and information systems. General and administrative expenses increased from \$26.3 million for the three months ended September 30, 2004 to \$34.3 million for the three months ended September 30, 2005, an increase of 30.1%. The increase in general and administrative expenses included \$3.7 million of transaction costs that we incurred in connection with the agreement by Fresenius Medical Care to acquire Renal Care Group. In addition, we experienced significant increases in legal costs during the third quarter of 2005 as we responded to the investigations under the subpoenas we received from the offices of the United States Attorney for the Eastern District of Missouri and the United States Attorney for the Eastern District of New York. General and administrative expenses as a percentage of net revenue increased from 7.4% in the 2004 period to 8.5% in the 2005 period. Excluding the effect of the \$3.7 million of costs related to the transaction with Fresenius Medicare Care, general and administrative costs as a percentage of revenue were 7.6% in the 2005 period. Management believes that we will continue to face increases in general and administrative expenses for the remainder of 2005 in connection with both the Fresenius Medical Care transaction and compliance with the New York and Missouri subpoenas.

Provision for Doubtful Accounts. Management determines the provision for doubtful accounts as a function of payor mix, billing practices and other factors. We reserve for doubtful accounts in the period when we recognize revenue based upon a variety of factors. These factors include, but are not limited to, analysis of the revenues

generated from payor sources, performing subsequent collection testing and regularly reviewing detailed accounts receivable agings. Management makes adjustments to the allowance for doubtful accounts as necessary based on the results of management's reviews of the net collectibility of accounts receivable.

The provision for doubtful accounts decreased from \$8.5 million for the three months ended September 30, 2004 to \$5.4 million for the three months ended September 30, 2005, a decrease of \$3.1 million, or 36.2%. The provision for doubtful accounts as a

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percentage of net revenue decreased from 2.4% in the 2004 period to 1.3% in the 2005 period. During the third quarter of 2005, we obtained notification of final determination of significant Medicare cost report amounts related to acquired National Nephrology Associates operations. As a result of these notifications, we recognized approximately \$4.3 million in Medicare cost report payments as a reduction in the provision for doubtful accounts. Excluding the impact of any additional Medicare bad debt recoveries, management expects the provision for doubtful accounts for the remainder of 2005 to be in our historic range of between 2.0% and 2.5% of net revenue.

Depreciation and Amortization. Depreciation and amortization increased from \$15.3 million for the three months ended September 30, 2004 to \$18.2 million for the three months ended September 30, 2005, an increase of 18.4%. This increase was due to the start-up of dialysis facilities, the normal replacement costs of dialysis facilities and equipment, and the amortization of separately identifiable intangible assets associated with acquisitions. Depreciation and amortization as a percentage of net revenue increased from 4.3% in 2004 to 4.5% in 2005.

Income from Operations. Income from operations increased from \$66.6 million for the three months ended September 30, 2004 to \$76.5 million for the three months ended September 30, 2005, an increase of 14.9%. Income from operations as a percentage of net revenue increased from 18.7% in the 2004 period to 19.0% in the 2005 period as a result of the combined effect of the factors described above.

Interest Expense, Net. Interest expense increased from \$6.9 million for the three months ended September 30, 2004 to \$8.7 million for the three months ended September 30, 2005. This increase was due to higher average borrowings outstanding during the quarter, which were primarily associated with recent acquisitions, as well as increases in the Company's weighted average borrowing rate under our term loans.

Minority Interest. Minority interest represents the proportionate equity interest of other owners in consolidated entities that we do not wholly own. The financial results of those entities are included in the Company's consolidated results. Minority interest as a percentage of net revenue decreased from 2.9% in the 2004 period to 2.5% in the 2005 period. The reduction in minority interest expense as a percentage of revenue was the result of our purchase of the interests of the minority partners in some of our joint ventures coupled with a slight decrease in the profitability of some of the facilities that we operate as joint ventures. During the third quarter of 2005, we purchased minority partner interests in seven joint ventures. As of September 30, 2005, we were the majority and controlling owner in 68 joint ventures.

Provision for Income Taxes. Income tax expense increased from \$19.1 million for the three months ended September 30, 2004 to \$22.6 million for the three months ended September 30, 2005, an increase of \$3.6 million or 18.7%. The increase is a result of higher pre-tax earnings described above. Our effective tax rate increased from 38.5% for the 2004 period to 39.1% in the 2005 period principally because a substantial portion of the \$3.7 million of costs associated with the Fresenius Medical Care transaction were not deductible for income tax purposes.

Net Income. Net income increased from \$30.5 million for the three months ended September 30, 2004 to \$35.2 million for the three months ended September 30, 2005, an increase of \$4.8 million or 15.6%. Excluding the \$3.7 million (\$2.9 million after tax) of costs associated with the Fresenius Medical Care transaction, our net income would have been \$38.1 million, an increase of approximately \$7.7 million or 25.1%.

Nine Months Ended September 30, 2004 Compared to Nine Months Ended September 30, 2005

Net Revenue. Net revenue increased from \$975.0 million for the nine months ended September 30, 2004 to \$1,160.1 million for the nine months ended September 30, 2005, an increase of \$185.1 million or 19.0%. This increase resulted primarily from a 16.5% increase in the number of treatments performed by Renal Care Group from 3,080,520 in the 2004 period to 3,587,959 in the 2005 period. This growth in treatments was the result of our acquisition of National Nephrology Associates, Inc. in April 2004 and the acquisition of other dialysis facilities, coupled with a 2.9% increase in same-market treatments for the 2005 period compared to the 2004 period. In addition, patient revenue per treatment increased 2.2% from \$315 in the 2004 period to \$322 in the 2005 period. The increase in patient revenue per treatment was largely due to the impact of price increases to our commercial payors and benefits from renegotiating certain managed care contracts, the effect of which was partially offset by the favorable resolution of contractual issues with payors during the first quarter 2004. In addition, net revenue per dialysis treatment increased modestly as a result of the net impact of Medicare's 1.6% composite rate increase and changes in its reimbursement for separately billable drugs, along with the case mix adjustment that became effective in April 2005, all of which

resulted from the Medicare Modernization Act. These favorable effects on our revenue per treatment were partially offset by increases in the percentage of our total net revenue that

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was derived from reimbursement under the Medicare and Medicaid programs, as well as decreases in the utilization of certain drugs, primarily EPO.

Patient Care Costs. Patient care costs increased from \$648.6 million for the nine months ended September 30, 2004 to \$769.3 million for the nine months ended September 30, 2005, an increase of 18.6%. This increase was due principally to the 16.5% increase in the number of treatments performed during the period, which resulted in corresponding increases in the use of labor, drugs and supplies. Patient care costs as a percentage of net revenue decreased slightly from 66.5% in the 2004 period to 66.3% in the 2005 period. Patient care costs per treatment increased 1.4% from \$211 in the 2004 period to \$214 in the 2005 period. This increase was generally due to the higher cost structure in the former NNA facilities, as well as higher labor and benefit costs and higher insurance costs. During the third quarter of 2005, we experienced cost increases in some of our insurance programs, primarily medical malpractice and workers compensation. Management believes that these costs along with salary and benefit costs will continue to increase through the remainder of 2005.

General and Administrative Expenses. General and administrative expenses increased from \$76.4 million for the nine months ended September 30, 2004 to \$101.0 million for the nine months ended September 30, 2005, an increase of 32.2%. General and administrative expenses as a percentage of net revenue increased from 7.8% in 2004 to 8.7% in 2005. This increase was primarily attributable to \$10.4 million of transaction costs we incurred in connection with the agreement by Fresenius Medical Care to acquire Renal Care Group. In addition, we experienced significant increases in legal costs as we responded to the investigations under the subpoenas received from the offices of the United States Attorney for the Eastern District of Missouri and the United States Attorney for the Eastern District of New York. Excluding the effect of the \$10.4 million of transaction costs, general and administrative costs as a percentage of revenue were 7.8% of net revenue during the nine months ended September 30, 2005.

Provision for Doubtful Accounts. We determine the provision for doubtful accounts as a function of payor mix, billing practices and other factors. We reserve for doubtful accounts in the period in which the revenue is recognized. Management establishes these reserves based on its estimates of the net collectibility of accounts receivable while considering a variety of factors. These factors include, but are not limited to, analysis of revenues generated from payor sources, subsequent collection testing and regular reviews of detailed accounts receivable agings. We make adjustments to the allowance for doubtful accounts as necessary based on the results of management's ongoing reviews of the net collectibility of accounts receivable.

The provision for doubtful accounts decreased from \$23.6 million for the nine months ended September 30, 2004 to \$22.5 million for the nine months ended September 30, 2005, a decrease of \$1.1 million, or 4.6%. The provision for doubtful accounts as a percentage of net revenue decreased from 2.4% in the 2004 period to 1.9% in the 2005 period. During the third quarter of 2005, we obtained notification of final determination of significant Medicare cost report amounts related to acquired National Nephrology Associates operations. As a result of these notifications we recognized approximately \$4.5 million in Medicare cost report payments as a reduction in the provision for doubtful accounts. Excluding the impact of any additional Medicare bad debt recoveries, management expects the provision for doubtful accounts for the remainder of 2005 to be in our historic range of between 2% and 2.5% of net revenue.

Depreciation and Amortization. Depreciation and amortization increased from \$42.4 million for the nine months ended September 30, 2004 to \$52.7 million for the nine months ended September 30, 2005, an increase of \$10.3 million, or 24.4%. This net increase was due to increases in plant and equipment, separately identifiable assets associated with our recent acquisitions, start-up of dialysis facilities, and the normal replacement costs of dialysis facilities and equipment. Depreciation and amortization as a percentage of net revenue increased from 4.3% in the 2004 period to 4.5% in the 2005 period.

Income from Operations. Income from operations increased from \$184.0 million for the nine months ended September 30, 2004 to \$214.5 million for the nine months ended September 30, 2005, an increase of \$30.5 million, or 16.6%. Income from operations as a percentage of net revenue decreased from 18.9% in the 2004 period to 18.5% in the 2005 period as a result of the combined effect of the factors described above.

Interest Expense, Net. Interest expense increased from \$13.6 million for the nine months ended September 30, 2004 to \$24.0 million for the n