

OPTION CARE INC/DE  
Form 10-Q  
August 09, 2005

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

For the quarterly period ended June 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 number 0-19878

**OPTION CARE, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or  
organization)

**485 Half Day Road, Suite 300  
Buffalo Grove, Illinois**

(Address of principal executive office)

**36-3791193**

(IRS Employer Identification No.)

**60089**

(zip code)

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(847) 465-2100

(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  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). 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	Issued and Outstanding as of August 1, 2005
Common Stock - \$0.01 par value	32,480,036

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INDEX

OPTION CARE, INC. AND SUBSIDIARIES

DESCRIPTION

**PART I**

**FINANCIAL INFORMATION**

Item 1.

Financial Statements (Unaudited)

Condensed consolidated balance sheets June 30, 2005 and December 31, 2004

Condensed consolidated statements of income Three and six months ended June 30, 2005 and 2004

Condensed consolidated statements of cash flows Six months ended June 30, 2005 and 2004

Notes to condensed consolidated financial statements June 30, 2005

Item 2.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 3.

Quantitative and Qualitative Disclosures about Market Risk

Item 4.

Controls and Procedures

**PART II**

**OTHER INFORMATION**

Item 1.

Legal Proceedings

Item 2.

Unregistered Sales of Equity Securities and Use of Proceeds

Item 3.

Defaults Upon Senior Securities

Item 4.

Submission of Matters to a Vote of Security Holders

Item 5.

Other Information

Item 6.

Exhibits

**SIGNATURES**

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## Option Care, Inc. and Subsidiaries

## Condensed Consolidated Balance Sheets

(in thousands, except per share amounts)

	June 30, 2005 (Unaudited)	December 31, 2004 (Note 1)
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 8,860	\$ 19,816
Short-term investments	71,598	75,370
Accounts receivable, net	72,575	69,930
Inventory	12,615	13,191
Deferred income tax benefit	2,938	3,098
Other current assets	8,259	5,459
Total current assets	176,845	186,864
Equipment and other fixed assets, net	16,267	13,709
Goodwill, net	85,289	65,356
Other assets	4,973	3,918
Total assets	\$ 283,374	\$ 269,847
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Trade accounts payable	\$ 16,786	\$ 21,819
Current portion of long-term debt	47	19
Other current liabilities	7,427	6,573
Total current liabilities	24,260	28,411
Long-term debt, less current portion	86,335	86,306
Deferred income tax liability	8,066	7,468
Other liabilities	582	551
Minority interest	597	548
Total liabilities	119,840	123,284
<b>Stockholders' equity:</b>		
Common stock, \$.01 par value per share, 60,000 shares authorized, 32,464 and 32,183 shares issued and outstanding at June 30, 2005 and December 31, 2004, respectively	325	322
Common stock to be issued, 189 and 114 shares at June 30, 2005 and December 31, 2004, respectively	2,140	1,085
Additional paid-in capital	109,840	108,062
Retained earnings	51,229	41,612
Less treasury stock, at cost, 474 shares at December 31, 2004		(4,518)

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Total stockholders' equity		163,534		146,563
Total liabilities and stockholders' equity	\$	283,374	\$	269,847

*See notes to condensed consolidated financial statements*

## Option Care, Inc. and Subsidiaries

## Condensed Consolidated Statements of Income

(Unaudited)

(in thousands, except per share amounts)

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
<b>Revenue:</b>				
Specialty pharmacy services	\$ 67,600	\$ 58,407	\$ 142,497	\$ 123,339
Infusion and related healthcare services	47,690	37,450	90,538	72,396
Other	4,201	2,794	7,211	6,065
Total revenue	119,491	98,651	240,246	201,800
<b>Cost of revenue:</b>				
Cost of goods sold	71,750	58,997	147,442	122,805
Cost of services provided	12,781	10,616	24,581	21,260
Total cost of revenue	84,531	69,613	172,023	144,065
Gross profit	34,960	29,038	68,223	57,735
<b>Operating expenses:</b>				
Selling, general and administrative expenses	23,509	19,200	45,050	38,449
Provision for doubtful accounts	2,153	1,462	4,479	3,021
Depreciation and amortization	849	569	1,753	1,250
Total operating expenses	26,511	21,231	51,282	42,720
Operating income	8,449	7,807	16,941	15,015
Interest income	194	34	150	35
Other income (expense), net	100	(12)	53	(79)
Income before income taxes	8,743	7,829	17,144	14,971
Income tax provision	3,334	3,128	6,450	5,985
Net income	\$ 5,409	\$ 4,701	\$ 10,694	\$ 8,986
<b>Net income per common share:</b>				
Basic	\$ 0.17	\$ 0.15	\$ 0.33	\$ 0.28
Diluted	\$ 0.16	\$ 0.14	\$ 0.32	\$ 0.28
<b>Shares used in computing net income per share:</b>				
Basic	32,559	31,923	32,332	31,782
Diluted	34,519	32,613	33,930	32,466
Cash dividends per share	\$ 0.0200	\$ 0.0133	\$ 0.0333	\$ 0.0133

See notes to condensed consolidated financial statements



## Option Care, Inc. and Subsidiaries

## Condensed Consolidated Statements of Cash Flows

(Unaudited)

(in thousands)

	Six Months Ended June 30,	
	2005	2004
Cash flows from operating activities:		
Net income	\$ 10,694	\$ 8,986
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	3,022	2,494
Provision for doubtful accounts	4,479	3,021
Deferred income taxes	663	1,473
Income tax benefit from exercise of stock options	1,388	1,148
Changes in assets and liabilities:		
Accounts and notes receivable	(3,066)	(1,205)
Inventory	1,546	2,495
Accounts payable	(5,693)	(3,685)
Income taxes receivable/payable	1,639	715
Change in other assets and liabilities	(2,715)	(3,582)
Net cash provided by operating activities	11,957	11,860
Cash flows from investing activities:		
Purchases of short-term investments	(135,288)	
Sales of short-term investments	139,060	
Purchases of equipment and other, net	(4,158)	(2,588)
Payments for acquisitions, net of cash acquired	(25,742)	(1,090)
Net cash used in investing activities	(26,128)	(3,678)
Cash flows from financing activities:		
Increase in financing costs	(161)	
Payments on capital leases and other debt	(13)	(387)
Proceeds from issuance of stock	4,466	2,403
Payments of cash dividends to common shareholders	(1,077)	(428)
Payments for purchase of treasury stock		(944)
Net cash provided by financing activities	3,215	644
Net increase (decrease) in cash and cash equivalents	(10,956)	8,826
Cash and cash equivalents, beginning of period	19,816	3,961
Cash and cash equivalents, end of period	\$ 8,860	\$ 12,787

See notes to condensed consolidated financial statements





**Option Care, Inc. and Subsidiaries**

**Notes to Condensed Consolidated Financial Statements**

**June 30, 2005**

(Unaudited)

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States 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 accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

The balance sheet at December 31, 2004 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

We completed a 3-for-2 split of our common stock on March 31, 2005 for shareholders of record as of March 17, 2005. All share and per share amounts in this Quarterly Report on Form 10-Q have been adjusted to reflect the pro forma effects of this stock split.

For further information, refer to the consolidated financial statements and footnotes thereto included in Option Care's Annual Report on Form 10-K for the year ended December 31, 2004.

**2. Long-Term Debt**

On November 2, 2004, we completed a \$75 million offering of 2.25% convertible senior notes due 2024 in a private placement to qualified institutional buyers. The initial purchasers were granted the option to purchase up to an additional \$11.3 million principal amount of notes and exercised this option in full on November 9, 2004. We filed a Registration Statement on Form S-3 with the Securities and Exchange Commission on January 24, 2005 registering the notes and the common stock issuable upon conversion of the notes for resale to the public.

The convertible notes are senior unsecured obligations of Option Care and will be convertible into cash and, if applicable, shares of our common stock based on an initial conversion rate of 55.5278 shares per \$1,000 principal amount of notes, which represents an initial conversion price of \$18.01 per share, subject to adjustment in certain circumstances. The conversion rate and conversion price were subsequently adjusted to 83.3338 and \$12.00 per share, respectively, pursuant to the terms of the notes as a result of our 3-for-2 common stock split on March 31, 2005 and \$0.02 per share dividend paid on June 10, 2005. Note holders may convert their notes into cash and, if applicable, shares of our common

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stock prior to the stated maturity only under the following circumstances: (1) during any calendar quarter beginning after December 31, 2004, if the closing sale price of our common stock for each of 20 or more consecutive trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 120% of the conversion price in effect on the last trading day of the immediately preceding calendar quarter; (2) during the five business day period after any five consecutive trading day period in which the average trading price per \$1,000 principal amount of notes was equal to or less than 97% of the average conversion value of the notes during the note measurement period; (3) upon the occurrence of specified corporate transactions; or (4) if we have called the notes for redemption. In general, upon conversion, the holder of each note will receive the conversion value of the note payable in cash, up to the principal amount of the note, and common stock for the notes' conversion value in excess of such principal amount (plus an additional cash payout in lieu of fractional shares). If the notes are surrendered for conversion in connection with certain fundamental changes that occur before November 1, 2009, holders will in certain circumstances also receive a make-whole premium in addition to the cash and shares that holders are otherwise entitled to receive upon conversion. The convertible senior notes will mature on November 1, 2024 and will not be redeemable by us prior to November 1, 2009. Holders of the convertible notes may require us to repurchase all or a portion of the convertible notes for cash on November 1, 2009, 2014 and 2019. Interest will be paid at 2.25% per annum, payable semi-annually in arrears on May 1 and November 1 of each year to the holders of record at the close of business on the preceding April 15 and October 15, respectively. The notes are senior unsecured obligations and will rank equally with all of our existing and future senior unsecured indebtedness.

### 3. Earnings Per Share Data

The following table sets forth the computation of basic and diluted earnings per share for the periods indicated. All share and per share amounts reflect the 3-for-2 stock split effective March 31, 2005 for shareholders of record on March 17, 2005. (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
<b>Basic:</b>				
Net income	\$ 5,409	\$ 4,701	\$ 10,694	\$ 8,986
Average shares outstanding	32,559	31,923	32,332	31,782
Basic earnings per share	\$ 0.17	\$ 0.15	\$ 0.33	\$ 0.28
<b>Diluted:</b>				
Net income	\$ 5,409	\$ 4,701	\$ 10,694	\$ 8,986
Average shares outstanding	32,559	31,923	32,332	31,782
Net effect of dilutive stock options Based on the treasury stock method	1,025	690	1,023	684
Net effect of dilutive contingently convertible debt (1)	935	—	575	—
Total diluted shares	34,519	32,613	33,930	32,466
Diluted earnings per share	\$ 0.16	\$ 0.14	\$ 0.32	\$ 0.28

(1) Weighted average shares issuable upon conversion of all \$86.3 million of our 2.25% convertible senior notes due 2024.

### 4. Operating Segments

We have one identifiable business segment, with three service lines: specialty pharmacy services; infusion and related healthcare services; and other.

**Specialty pharmacy services** involve the distribution of injectible and infused pharmaceuticals to treat a wide range of chronic health conditions. The pharmaceuticals can be directly distributed to the patient's home or to their physician's office for in-office administration. These pharmaceuticals may require refrigeration during shipping as well as special handling to prevent potency degradation. Patients receiving treatment usually require special counseling and education regarding their condition and treatment program.

**Infusion and related healthcare services** primarily involve the intravenous administration of medications at the patient's home or other non-hospital sites such as one of our infusion suites. Infusion pharmacy services treat a wide range of acute and chronic health conditions, including infections, dehydration, cancer, pain and nutritional deficiencies. All of our company-owned pharmacies provide infusion pharmacy services. Some of these pharmacies also provide related healthcare services, such as home health nursing, home hospice services, respiratory therapy services and durable medical equipment.

**Other revenue** consists of royalties and other fees generated from our franchised pharmacy network and the software licensing and support revenue generated by our subsidiary, Management by Information, Inc. ( MBI ).

#### **5. Significant Customers and Concentration of Credit Risk**

We generate the majority of our revenue from managed care contracts and other agreements with commercial third party payors by providing health care services to their members. Our principal managed care contract is with Blue Cross and Blue Shield of Florida, to whose members we provide infusion pharmacy services and specialty pharmacy services. The contract may be terminated by either party on 90 days' notice and, unless terminated, renews annually each September for an additional one-year term. We also generate revenue from government healthcare programs such as Medicare and Medicaid.

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The following table sets forth information regarding revenue and accounts receivable related to our most significant payors as of the dates and for the periods presented:

	Revenue				Accounts Receivable	
	Three months ended June 30,		Six months ended June 30,		June 30,	December 31,
	2005	2004	2005	2004	2005	2004
Blue Cross and Blue Shield of Florida	14%	16%	14%	15%	9%	7%
Medicare & Medicaid	17%	20%	17%	20%	20%	18%
All other payors (1)	69%	64%	69%	65%	71%	75%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

(1) No other payor represents 10% or more of revenue or accounts receivable as of the dates and for the periods presented.

### 6. Seasonal Revenue Trends

Synagis®, one of the specialty pharmaceuticals that we provide to patients, is seasonal. Synagis® is a drug used for the prevention of respiratory syncytial virus (RSV) in high-risk pediatric patients. RSV infection is a seasonal condition, with the season generally lasting from October through April.

Option Care's quarterly Synagis® revenue for the year 2004 and the first two quarters of 2005 was as follows (amounts in thousands):

	Synagis® revenue	% of Total Revenue
Quarter ended March 31, 2004	\$ 14,251	13.8%
Quarter ended June 30, 2004	3,955	4.0%
Quarter ended September 30, 2004	571	0.6%
Quarter ended December 31, 2004	9,455	8.4%
Fiscal year 2004	\$ 28,232	6.8%
Quarter ended March 31, 2005	\$ 15,536	12.9%
Quarter ended June 30, 2005	\$ 4,492	3.8%

### 7. Acquisitions

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During the quarter ended June 30, 2005, we completed three acquisitions of home infusion pharmacy businesses. Two of the acquired businesses were current or former Option Care franchises, while the third was an independent, non-affiliated home infusion provider. On April 8, 2005, we acquired the assets of our franchisee serving Indianapolis, Indiana and surrounding areas. Effective May 1, 2005, we acquired the outstanding stock of an independent home infusion pharmacy business operating in Montana. As of June 1, 2005, we acquired the outstanding stock of our former franchisee in Bakersfield, California. These acquisitions continued our objective of expanding our overall national presence of company-owned home infusion pharmacies. We have consolidated the results of operations of these businesses as of the effective dates of the acquisitions. We used \$18.7 million in cash upon closing these transactions and will also issue 48,315 shares of our common stock, valued at a market price of \$13.31 per share, in an unregistered offering. Each acquisition contains a provision for payment of additional consideration in future periods if various performance measures are achieved. We anticipate that any such additional consideration would be recorded as goodwill. From the initial purchase payments, we recorded \$12.9 million in goodwill from these transactions and expect the entire amount to be deductible for income tax purposes.

The following table sets forth the allocation of purchase price, in aggregate, for the three acquisitions we completed in the quarter ended June 30, 2005. For certain of our acquisitions, the allocation of purchase price is tentative and subject to adjustment based on final valuation of the acquired assets (amounts in thousands):

<b>Purchase Price:</b>		
Paid in cash at closing	\$	18,643
Payable in shares of Option Care common stock		643
Liabilities assumed		310
<b>Total purchase price</b>	<b>\$</b>	<b>19,596</b>
<b>Allocation of Purchase Price:</b>		
Accounts receivable	\$	5,114
Inventory		736
Other tangible assets		625
Goodwill		12,901
Other intangible assets		220
<b>Total purchase price</b>	<b>\$</b>	<b>19,596</b>

In addition to our new acquisitions, during the six months ended June 30, 2005, we recorded \$500,000 in goodwill equal to the additional cash consideration we expect to pay related to our 2004 acquisitions. The additional consideration is based upon the achievement of performance targets contained in the purchase agreements for the acquired businesses. This additional goodwill is expected to be fully deductible for income tax purposes.

## 8. Franchise-related Revenue

We maintain a national franchise network through which we generate a portion of our revenue. Our franchise-related revenues include: (1) royalties; (2) vendor rebates and administration fees; and (3) franchise settlement and related fees. Each of these types of revenue can fluctuate over time, with the largest potential fluctuations relating to franchise terminations.

During the six months ended June 30, 2005, we recorded franchise settlement revenue related to two of our former franchisees. During the quarter ended June 30, 2005, we recorded \$2.0 million related to the termination of one of our franchisees, of which \$1.7 million was related to release of future obligations under the franchise agreement and \$300,000 represented settlement of under-reported royalties from prior periods discovered during our audit of their books and records. During the quarter ended March 31, 2005, we acquired our franchise in St. Cloud, Minnesota. As part of the transaction, we terminated the franchise agreement early and recorded a settlement gain of \$800,000, which was equal to the present value of the excess of the estimated future royalty payments receivable under the franchise agreement over current market rates.

During the quarter and six months ended June 30, 2004, we recorded revenue of \$400,000 and \$900,000, respectively, related to the termination of one of our franchisees. This revenue was primarily related to the amortization of a non-competition agreement we signed with the buyers of the franchisee's business. We also recorded \$100,000 in revenue during the quarter ended March 31, 2004 related to a settlement reached with a former franchisee that had been terminated in 2003.

Our franchise-related revenue is included in our Other service line. The following table sets forth our franchise-related revenue for the periods indicated (in thousands):



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	Three months ended		Six months ended	
	June 30,		June 30,	
	2005	2004	2005	2004
<u>Franchise-related revenue:</u>				
Royalties	\$ 2,105	\$ 1,983	\$ 3,915	\$ 4,077
Vendor rebates and administration fees	95	125	189	287
Franchise settlements and related fees	1,700	392	2,491	1,036
Total franchise-related revenue	\$ 3,900	\$ 2,500	\$ 6,595	\$ 5,400

## 9. Stock-based Compensation

Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, as amended by Statement of Financial Accounting Standards No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure*, encouraged, but did not require, companies to record compensation cost for stock-based compensation plans at fair value. We have chosen to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the quoted market price of Option Care common stock at the date of grant over the amount an employee must pay to acquire the stock. We grant options at fair market value and therefore recognize no compensation expense when options are granted. Likewise, our Employee

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Stock Purchase Plan was structured to qualify under Section 423 of the Internal Revenue Code. Therefore, no compensation expense is recognized from employees' purchase of shares under this plan.

The following table sets forth our net income and net income per common share for the three and six months ended June 30, 2005 and 2004, had compensation cost for our stock-based compensation plan been determined based on FASB Statement No. 123. All share and per share amounts in the following table have been adjusted to reflect the pro forma effects of the 3-for-2 split of our common stock that became effective March 31, 2005 for shareholders of record on March 17, 2005 (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
<b>Net income:</b>				
As reported	\$ 5,409	\$ 4,701	\$ 10,694	\$ 8,986
Deduct: Total stock-based employee compensation expense determined under the fair value based method for the following awards, net of related tax effects:				
Stock option grants	(239)	(367)	(462)	(699)
Employee stock purchase plan withholdings	(63)	(33)	(127)	(68)
Pro forma	\$ 5,107	\$ 4,301	\$ 10,105	\$ 8,219
<b>Net income per common share - basic:</b>				
As reported	\$ 0.17	\$ 0.15	\$ 0.33	\$ 0.28
Pro forma	\$ 0.16	\$ 0.13	\$ 0.31	\$ 0.26
<b>Net income per common share - diluted:</b>				
As reported	\$ 0.16	\$ 0.14	\$ 0.32	\$ 0.28
Pro forma	\$ 0.15	\$ 0.13	\$ 0.30	\$ 0.25

The fair value of options granted under our stock option plan during the three and six months ended June 30, 2005 and 2004 was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions (as pro forma adjusted for our 3-for-2 stock split on March 31, 2005):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Annual dividend yield per share	\$ 0.08	\$ 0.05	\$ 0.08	\$ 0.05
Expected volatility	30%	40%	33%	40%
Weighted average risk-free interest rate	3.72%	3.10%	3.66%	2.86%
Expected grant life (years)	4.0	4.0	4.0	4.0
Weighted average per share fair value of options granted	\$ 3.92	\$ 2.93	\$ 3.99	\$ 2.85

## 10. Recently Issued Accounting Pronouncement

On December 16, 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, which will change the way we account for employee stock options in future periods. SFAS No. 123(R), which is a

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revision to SFAS No. 123, *Accounting for Stock-Based Compensation*, 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, but with certain enhancements to improve the accuracy of fair value estimates. However, SFAS 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.

SFAS No. 123(R) permits public companies to adopt its requirements using one of two methods:

- A modified prospective method in which compensation cost is recognized beginning with the effective date
- (a) based on the requirements of Statement 123(R) for all share-based payments granted after the effective date and
- (b) based on the

requirements of SFAS No. 123 for all awards granted to employees prior to the effective date of Statement 123(R) that remain invested on the effective date.

A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS No. 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

Initially, the SEC announced that SFAS No. 123(R) must be adopted in the first interim or annual period beginning after June 15, 2005. Subsequently, on April 14, 2005, the SEC announced that calendar year-end companies will be allowed to delay implementation of the new standard until their first interim period beginning after December 15, 2005.

We will adopt SFAS No. 123(R) in our fiscal quarter ending March 31, 2006 and intend to apply the modified retrospective method. Adoption of SFAS No. 123(R) may materially affect our results of operations for periods following adoption, but will have no effect on our financial condition.

## 11. Quarterly Dividends

Our Board of Directors initiated a quarterly dividend policy on May 11, 2004 and we paid our first quarterly dividend in the quarter ended June 30, 2004. During the quarter ended June 30, 2005, our Board of Directors declared a \$0.02 per share dividend paid on June 10, 2005 to shareholders of record as of May 27, 2005. In each of the preceding four quarters, we paid dividends of \$0.0133 per share.

## 12. Comprehensive Income

Net income was our only component of comprehensive income for the three and six months ended June 30, 2005 and 2004.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### FORWARD LOOKING STATEMENTS

The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2004. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Certain information included in this Quarterly Report on Form 10-Q and other materials filed or to be filed by us with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by us) contain statements that are or will be forward-looking, such as statements relating to acquisitions and other business development activities, future capital expenditures and the effects of future regulation and competition. Such forward-looking information involves important risks and uncertainties that could significantly affect anticipated results in the future and, accordingly, such results may differ from those expressed in any forward-looking statements made by us, or on our behalf. These risks and uncertainties include, but are not limited to, uncertainties affecting our businesses and our franchisees relating to acquisitions and divestitures (including continuing obligations with respect to completed transactions), sales and renewals of franchises, government and regulatory policies (including federal, state and local efforts to reform the delivery of and payment for healthcare services), general economic conditions (including economic conditions affecting the healthcare industry in particular), the pricing and availability of equipment and services, technological developments and changes in the competitive environment in which we operate. For a more comprehensive description of risks applicable to our business, see Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2004.

### OVERVIEW

We provide specialty pharmacy services and infusion pharmacy and other related healthcare services to patients at home or at other alternate sites such as infusion suites and physician's offices. We contract with managed care organizations and other third party payors who reimburse us for the services we provide to their subscriber members. Our services are provided through our national network of company-owned and franchise-owned pharmacies and our two central, high-volume drug distribution facilities.

We have three service lines: specialty pharmacy services, infusion and related healthcare services, and other. Specialty pharmacy services involve the distribution of injectible and infused pharmaceuticals to treat a wide range of chronic health conditions. The pharmaceuticals can be directly distributed to the patient's home or to their physician's office for in-office administration. Depending on therapy type, we may also administer specialty pharmaceuticals to patients at our ambulatory infusion centers. These pharmaceuticals may require refrigeration during shipping as well as special handling to prevent potency degradation. Patients receiving treatment usually require special counseling and education regarding their condition and treatment program. Infusion and related services primarily involves the intravenous administration of medications at the patient's home or other non-hospital site such as one of our infusion suites. Infusion pharmacy services treat a wide range of acute and chronic health conditions, including infections, dehydration, cancer, pain and nutritional deficiencies. All of our company-owned pharmacies provide infusion therapies. Some of these pharmacies also provide related healthcare services, such as home health nursing, home hospice services, respiratory therapy services and durable medical equipment. Other revenue consists of royalties and other fees generated from our franchised pharmacy network and the software licensing and support revenue generated by our subsidiary, MBI.

Summarized information about revenues and gross profit for each of our service lines is provided in the following table (amounts in thousands):

### REVENUE

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	Three months ended June 30,				Six months ended June 30,			
	2005		2004		2005		2004	
	Revenue	% of total	Revenue	% of total	Revenue	% of total	Revenue	% of total
Specialty pharmacy services	\$ 67,600	56.6%	\$ 58,407	59.2%	\$ 142,497	59.3%	\$ 123,339	61.1%
Infusion and related healthcare services	47,690	39.9%	37,450	38.0%	90,538	37.7%	72,396	35.9%
Other	4,201	3.5%	2,794	2.8%	7,211	3.0%	6,065	3.0%
Total revenue	\$ 119,491	100.0%	\$ 98,651	100.0%	\$ 240,246	100.0%	\$ 201,800	100.0%

**GROSS PROFIT**

	Three months ended June 30,				Six months ended June 30,			
	2005		2004		2005		2004	
	Gross Profit	Gross profit margin	Gross Profit	Gross profit margin	Gross Profit	Gross profit margin	Gross Profit	Gross profit margin
Specialty pharmacy services	\$ 10,307	15.2%	\$ 10,059	17.2%	\$ 21,860	15.3%	\$ 20,585	16.7%
Infusion and related healthcare services	20,555	43.1%	16,334	43.6%	39,353	43.5%	31,363	43.3%
Other	4,098	97.6%	2,645	94.7%	7,010	97.2%	5,787	95.4%
Total gross profit	\$ 34,960	29.3%	\$ 29,038	29.4%	\$ 68,223	28.4%	\$ 57,735	28.6%

The majority of our revenue is generated from managed care contracts and other agreements with commercial third party payors. Our principal managed care contract is with Blue Cross Blue Shield of Florida. For the three and six months ended June 30, 2005, approximately 14% of our revenue was generated from this contract compared to 16% and 15%, respectively, for the corresponding periods in the prior year. As of June 30, 2005 and December 31, 2004, respectively, 9% and 7% of our accounts receivable was due from Blue Cross Blue Shield of Florida. The contract may be terminated by either party on 90 days notice and, unless terminated, renews annually each September for an additional one-year term.

We also generate revenue from government healthcare programs such as Medicare and Medicaid. For the three and six months ended June 30, 2005, approximately 17% of our revenue was generated from government healthcare programs compared to 20% for the corresponding three and six month periods in the prior year. As of June 30, 2005 and December 31, 2004, respectively, 20% and 18% of our total accounts receivable was due from government healthcare programs.

**RESULTS OF OPERATIONS**

The following table shows the results of our operations for the three and six months ended June 30, 2005 and 2004, expressed in amounts and percentages of revenue (amounts in thousands):

	Three months ended June 30,				Six months ended June 30,			
	2005		2004		2005		2004	
	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue	Amount	% of Revenue
<b>Revenue:</b>								
Specialty pharmacy services	\$ 67,600	56.6%	\$ 58,407	59.2%	\$ 142,497	59.3%	\$ 123,339	61.1%
Infusion and related healthcare services	47,690	39.9%	37,450	38.0%	90,538	37.7%	72,396	35.9%
Other	4,201	3.5%	2,794	2.8%	7,211	3.0%	6,065	3.0%
<b>Total revenue</b>	<b>119,491</b>	<b>100.0%</b>	<b>98,651</b>	<b>100.0%</b>	<b>240,246</b>	<b>100.0%</b>	<b>201,800</b>	<b>100.0%</b>
<b>Cost of revenue:</b>								
Cost of goods sold	71,750	60.0%	58,997	59.8%	147,442	61.4%	122,805	60.9%
Cost of services provided	12,781	10.7%	10,616	10.8%	24,581	10.2%	21,260	10.5%
<b>Total cost of revenue</b>	<b>84,531</b>	<b>70.7%</b>	<b>69,613</b>	<b>70.6%</b>	<b>172,023</b>	<b>71.6%</b>	<b>144,065</b>	<b>71.4%</b>
<b>Gross profit</b>	<b>34,960</b>	<b>29.3%</b>	<b>29,038</b>	<b>29.4%</b>	<b>68,223</b>	<b>28.4%</b>	<b>57,735</b>	<b>28.6%</b>
<b>Selling, general and administrative expenses</b>								
Selling, general and administrative expenses	23,509	19.7%	19,200	19.5%	45,050	18.7%	38,449	19.1%
Provision for doubtful accounts	2,153	1.8%	1,462	1.5%	4,479	1.9%	3,021	1.5%
Depreciation and amortization	849	0.7%	569	0.5%	1,753	0.7%	1,250	0.6%
<b>Total operating expenses</b>	<b>26,511</b>	<b>22.2%</b>	<b>21,231</b>	<b>21.5%</b>	<b>51,282</b>	<b>21.3%</b>	<b>42,720</b>	<b>21.2%</b>
<b>Operating income</b>	<b>8,449</b>	<b>7.1%</b>	<b>7,807</b>	<b>7.9%</b>	<b>16,941</b>	<b>7.1%</b>	<b>15,015</b>	<b>7.4%</b>
Interest income (expense), net	194	0.1%	34	%	150	%	35	%
Other expense, net	100	0.1%	(12)	%	53	%	(79)	%
<b>Income before income taxes</b>	<b>8,743</b>	<b>7.3%</b>	<b>7,829</b>	<b>7.9%</b>	<b>17,144</b>	<b>7.1%</b>	<b>14,971</b>	<b>7.4%</b>
<b>Income tax provision</b>	<b>3,334</b>	<b>2.8%</b>	<b>3,128</b>	<b>3.1%</b>	<b>6,450</b>	<b>2.6%</b>	<b>5,985</b>	<b>2.9%</b>
<b>Net income</b>	<b>\$ 5,409</b>	<b>4.5%</b>	<b>\$ 4,701</b>	<b>4.8%</b>	<b>\$ 10,694</b>	<b>4.5%</b>	<b>\$ 8,986</b>	<b>4.5%</b>

**Three and Six Months Ended June 30, 2005 and 2004**



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For the quarter ended June 30, 2005, we generated revenue of \$119.5 million, an increase of 21.1% over the corresponding prior year quarter. For the six months ended June 30, 2005, our revenue was \$240.2 million, and increase of 19.1% over the prior year. This revenue growth was the result of acquisitions, start-ups and an increase in same store sales. Gross profit margins remained steady across most therapies, with the exception of IVIG (immune globulin). Supply shortages of IVIG throughout 2005 have significantly increased its cost, reducing our margin on this therapy. Our overall specialty pharmacy gross profit margin declined to 15.2% in the quarter ended June 30, 2005 compared to 17.2% in the corresponding prior year quarter, primarily due to the increased cost of IVIG. Despite this margin pressure, our net income increased by 15.1% to \$5.4 million for the quarter ended June 30, 2005 compared to \$4.7 million in the prior year quarter as a result of revenue growth through increased same store sales, acquisitions and start-ups, and an increase in franchise-related revenue. For the six months ended June 30, 2005, net income was \$10.7 million, an increase of 19.0% over the \$9.0 million net income in the prior year period. Net income per diluted share was \$0.16 for the quarter and \$0.32 for the six months ended June 30, 2005, compared to \$0.14 and \$0.28 for the respective quarter and six months in the prior year. We paid a cash dividend of \$0.02 per share during the quarter ended June 30, 2005 compared to \$0.0133 in the prior year quarter.

Our operating cash flow has continued to be positive. We generated \$12.0 million in cash from operations during the six months ended June 30, 2005 with \$4.8 million of this total generated in the quarter ended June 30, 2005. We used \$25.7 million in cash to complete five business acquisitions thus far in 2005, with three of these acquisitions taking place in the quarter ended June 30,

2005. We plan to continue evaluating potential acquisitions that we believe will add to shareholders value, as well as pursuing start-ups and strategic joint ventures. We will also continue to pursue opportunities to expand our business through increased market penetration and by partnering with biotech manufacturers on the release of new specialty drugs. As of June 30, 2005, we had \$8.9 million of cash and cash equivalents and \$71.6 million in short-term investments, while our debt primarily consisted of \$86.3 million of 2.25% convertible senior notes due 2024.

**Revenue:**

We report our operating results in one segment, consisting of three service lines: specialty pharmacy services; infusion and related healthcare services; and other. For the three and six months ended June 30, 2005, our revenue was \$119.5 million and \$240.2 million, respectively, representing increases of 21.1% and 19.1% over the corresponding prior year periods. Our increases in revenue were primarily due to same store sales growth and from the effects of acquisitions and start-ups.

**Specialty pharmacy services revenue:**

Our specialty pharmacy services revenue for the quarter ended June 30, 2005 was \$67.6 million, an increase of \$9.2 million, or 15.7%, over the corresponding prior year quarter. For the six months ended June 30, 2005, specialty revenue was \$142.5 million, an increase of \$19.2 million, or 15.5%, over the corresponding period in the prior year. Three main factors contributed to this growth: acquisitions and startups; increased sales of Xolair; and increased market penetration for various other specialty drugs and therapies. We completed three acquisitions during the quarter ended June 30, 2005 and five acquisitions overall so far this year. All of the acquired businesses are infusion therapy providers that also distribute specialty drugs for various therapies, adding to our revenue base for both of these service lines. Our Xolair revenue steadily increased throughout 2004 after the drug became available late in 2003 for the treatment of moderate to severe allergic asthma. We continue to see sequential quarterly increases in sales of Xolair, but at a more modest rate than during 2004. In addition, revenue from various other specialty products, such as growth hormone and blood clotting factor, increased on a same store basis during the current year periods as a result of focused marketing efforts. On a sequential quarterly basis, our specialty pharmacy services revenue decreased due to the seasonal effect of Synagis, a drug used during the colder months to prevent respiratory syncytial virus infection in premature and other high-risk infants. With the wind-down of the current Synagis season, our Synagis revenue declined to \$4.5 million in the quarter ended June 30, 2005 compared to \$15.5 million in the quarter ended March 31, 2005.

**Infusion and related healthcare services revenue:**

Our infusion and related healthcare services revenue for the quarter ended June 30, 2005 was \$47.7 million, an increase of \$10.2 million, or 27.3%, over the prior year quarter. For the six months ended June 30, 2005, infusion and related healthcare services revenue was \$90.5 million, an increase of \$18.1million, or 25.1%, over the corresponding prior year quarter. Our increases in revenue have been due to same store sales growth, acquisitions, and start-ups. Same store sales have grown at a rate of 12.2% in the quarter ended June 30, 2005 compared to the prior year quarter, and 14.0% in the six months ended June 30, 2005 compared to the corresponding prior year period. Increases have occurred across a wide variety of therapies.

**Other revenue:**

Other revenue consists of two primary elements: (1) revenue generated from our franchise network, consisting of royalties, franchise fees and vendor rebates earned through our franchisees purchases under our contracts, and; (2) software licensing and support services provided by our wholly-owned subsidiary, MBI. Other revenue was \$4.2 million for the quarter ended June 30, 2005 compared to \$2.8 million in the corresponding prior year quarter. For the six months ended June 30, 2005, other revenue was \$7.2 million compared to \$6.1 million in the prior year period. These increases in other revenue in the current year periods were due to franchise terminations, audits and settlements. Franchise-related revenue may continue to fluctuate significantly in future periods due to our potential acquisition, audit or termination of various franchises. Our software revenue in the current periods was immaterial in amount and consistent with the prior year periods.

**Cost of revenue:**

Cost of revenue consists of the cost of goods sold and the cost of service provided. Cost of goods primarily consists of the cost of drugs and medical supplies used in the provision of services to our patients, as well as depreciation expense for medical equipment rented to patients. Cost of service consists of salaries and related costs for employees directly involved in patient care, including pharmacists, nurses, therapists and delivery drivers. Cost of service also includes the cost of shipping or delivering products and services to the patient, including depreciation of delivery vehicles.

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The following table presents our cost of revenue for the quarter and six months ended June 30, 2005 and 2004 (in thousands):

	Three months ended June 30,				Six months ended June 30,			
	2005	2004	Dollar Change	Percent Change	2005	2004	Dollar Change	Percent Change
Cost of revenue:								
Cost of goods sold	\$ 71,750	\$ 58,997	\$ 12,753	21.6%	\$ 147,442	\$ 122,805	\$ 24,637	20.1%
Cost of services provided	12,781	10,616	2,165	20.4%	24,581	21,260	3,321	15.6%
Total cost of revenue	\$ 84,531	\$ 69,613	\$ 14,918	21.4%	\$ 172,023	\$ 144,065	\$ 27,958	19.4%

The increases in cost of revenue of 21.4% and 19.4% for the quarter and six months ended June 30, 2005 over the respective prior year periods were primarily due to our 21.1% and 19.1% increases in revenue over the same periods. Cost of goods sold increased at a higher rate than revenue primarily because of supply shortages for IVIG which resulted in a higher cost of goods and lower gross profit margin for that drug, and due to increased sales of Xolair in the current year periods.

**Gross profit margin.** The following table sets forth the gross profit margin for each of our three service lines: specialty pharmacy services; infusion and related healthcare services; and other:

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Gross profit margin:				
Specialty pharmacy services	15.2%	17.2%	15.3%	16.7%
Infusion and related healthcare services	43.1%	43.6%	43.5%	43.3%
Other	97.6%	94.7%	97.2%	95.4%
Overall gross profit margin	29.3%	29.4%	28.4%	28.6%

Our overall gross profit margins in the current year have remained consistent with the prior year. Within our services lines, the gross profit margin on our specialty pharmacy services has decreased, the margin on infusion and related healthcare services has remained steady and the margin on our other revenue has increased. Our specialty pharmacy services gross profit margin declined by 200 basis points in the quarter ended June 30, 2005 compared to the prior year quarter and 140 basis points in the six months ended June 30, 2005 compared to the corresponding prior year period. This decline was primarily due to supply shortages of IVIG which drove up the cost of that drug and reduced our gross profit margins. Our margin on other revenue improved in 2005 due to an increase in franchise-related revenue related to our acquisition of one franchisee and termination of another. Other revenue, which consists of franchise-related revenues and software sales and support, has minimal direct costs and therefore produces a high gross profit margin. Our infusion and related healthcare services gross profit margins have remained fairly consistent. The 50 basis point decline in margin for infusion and related healthcare services in the quarter ended June 30, 2005 was due to a one-time adjustment to depreciation expense for certain respiratory equipment as a result of a change in our estimate of useful life.

**Selling, general and administrative expenses:**

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For the quarter ended June 30, 2005, selling, general and administrative expenses were \$23.5 million, an increase of \$4.3 million, or 22.4% over the prior year quarter. For the six months ended June 30, 2005, selling, general and administrative expenses were \$45.1 million, an increase of \$6.6 million, or 17.2%, over the prior year period. Wages and related costs increased by \$3.2 million and \$5.0 million in the quarter and six months ended June 30, 2005 as a result of business acquisitions, increases in corporate and field staff and merit wage adjustments. Travel-related expenses, professional services and building rent also increased, in part due to acquisitions and acquisition-related activities. Professional services also increased in part due to incremental costs of complying with Section 404 of the Sarbanes-Oxley Act of 2002.

### **Provision for doubtful accounts:**

Our provision for doubtful accounts for the quarter ended June 30, 2005 was \$2.2 million, or 1.8% of revenue, compared to \$1.5 million, or 1.5% of revenue, in the prior year period. For the six months ended June 30, 2005, our provision for doubtful accounts was \$4.5 million, or 1.9% of revenue, compared to \$3.0 million, or 1.5% of revenue, in the corresponding prior year period. The slight

increase in our provision for doubtful accounts in both dollar amount and percentage of revenue was primarily due to the effects of our acquisitions and growth in same store sales at our company-owned local pharmacies. We provide for doubtful accounts at a higher rate at our local pharmacies than at our two high-volume distribution pharmacies. Therefore, as we acquired additional local pharmacies and generated higher revenue at our existing local pharmacies, our blended bad debt provision rate increased slightly in the current year periods as a percentage of revenue.

**Depreciation and amortization:**

For the quarter ended June 30, 2005, depreciation and amortization expense was \$800,000, an increase of \$300,000, or 49.2%, over the corresponding prior year quarter. For the six months ended June 30, 2005, our depreciation and amortization expense was \$1.8 million, an increase of \$500,000, or 40.2%, over the corresponding prior year period. The primary causes of these increases are the depreciation of internally-developed software products and the amortization of deferred financing costs generated by our \$86.3 million offering of 2.25% convertible senior notes, completed in November 2004. The depreciation expense contained within this line item relates to non-revenue producing assets only, such as furniture and fixtures and leasehold improvements. Depreciation for revenue-producing equipment such as rental medical equipment and delivery vehicles is included in cost of revenue.

**Operating income:**

Our operating income was \$8.4 million in the quarter ended June 30, 2005, an increase of \$600,000, or 8.2%, over the corresponding prior year quarter. For the six months ended June 30, 2005, our operating income was \$16.9 million, which represents an increase of \$1.9 million, or 12.8%, over the prior year period. These increases in operating income were primarily the result of same store sales growth, acquisition activities and an increase in franchise-related revenue. As a percentage of revenue, our operating income was 7.1% for the quarter and six months ended June 30, 2005 compared to 7.9% for the quarter ended June 30, 2004 and 7.4% for the six months ended June 30, 2004. These declines were primarily due to supply shortages of IVIG, which reduced our gross profit margin on this product and reduced our operating income in the current year periods.

**Interest Income/(Expense):**

Our interest income, net of interest expense, was \$194,000 and \$150,000 for the quarter and six months ended June 30, 2005, respectively. In the prior year periods, our interest income was \$34,000 and \$35,000 for the respective quarter and six months ended June 30, 2004. We completed an \$86.3 million offering of 2.25% convertible senior notes in November 2004. In the current year periods, our interest expense was primarily from these convertible notes and our interest income was earned from investing the proceeds from this debt offering. The interest earned on our investments exceeded the interest expense on the convertible notes, resulting in net interest income during the current year periods. In the prior year periods, we had virtually no debt and our net interest income was earned from investing our cash reserves.

**Income taxes:**

Our income tax provision was \$3.3 million for the quarter and \$6.5 million for the six months ended June 30, 2005. In the prior year, our income tax provision was \$3.1 million for the quarter and \$6.0 million for the six months ended June 30, 2004. As a percentage of pre-tax income, our provision for income taxes was 38.1% for the quarter and 37.6% for the six months ended June 30, 2005 compared to 40.0% for the corresponding prior year periods. The decline in income tax provision as a percentage of pre-tax income is primarily due to two factors: re-evaluation of our effective state income tax rate based on our reduced state tax exposure reserve; and an increase in tax-exempt interest income earned from our short-term investments.

**Net income:**

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Our net income was \$5.4 million for the quarter and \$10.7 million for the six months ended June 30, 2005 compared to \$4.7 million for the quarter and \$9.0 million for the six months ended June 30, 2004. Our growth in revenue from same store sales increases, acquisitions and start-ups and an increase in franchise termination revenue were the primary causes of our increase in net income over the period. As a percentage of revenue, our net income was equal to 4.5% for both the quarter and six months ended June 30, 2005 compared to 4.8% for the quarter and 4.5% for the six months ended June 30, 2004.

### **Diluted shares & earnings per share:**

We completed a 3-for-2 stock split on March 31, 2005. All share and per share amounts in this quarterly report reflect the pro forma effects of this split. Our earnings per diluted share were \$0.16 for the quarter and \$0.32 for the six months ended June 30, 2005, representing increases of 14.3% over our earnings per diluted share of \$0.14 for the quarter and \$0.28 for the six months ended June 30, 2004. Total diluted shares were 34.5 million for the quarter and 33.9 million for the six months ended June 30, 2005 compared to diluted shares of 32.6 million for the quarter and 32.5 million for the six months ended June 30, 2004. These increases in diluted shares were due to a number of factors, including (1) an increase in the dilutive effect of our contingently convertible debt, (2) the dilutive effect of employee stock options and shares issued and issuable under our employee stock purchase plan and stock incentive plan, and (3) new shares issued and to be issued as partial payment for acquisitions. These increases were partially offset by our purchase and subsequent retirement of 474,000 shares of treasury stock in the quarter ended December 31, 2004. Our contingently

convertible debt accounted for 900,000 shares of the total 1.9 million share increase in diluted shares for the quarter ended June 30, 2005 over the corresponding prior year quarter.

## **LIQUIDITY AND CAPITAL RESOURCES**

During the six months ended June 30, 2005, we financed our operations and business acquisitions through operating cash flows and the use of cash reserves and proceeds generated from our \$86.3 million offering of 2.25% convertible senior notes, completed in November 2004. During the six months ended June 30, 2005, we generated \$12.0 million in cash flow from operations. We also used \$25.7 million in cash during this period for business acquisitions. We continue to evaluate opportunities for potential business acquisitions, start-ups and joint ventures that we believe will be accretive to future earnings. Accordingly, we may need to seek additional sources of capital in the future to fund these activities. As of June 30, 2005, we had cash and short-term investments totaling \$80.5 million and total long-term debt of \$86.3 million.

### **Operating Cash Flows:**

We generated \$12.0 million in positive cash flow from operations in the six months ended June 30, 2005. This positive cash flow was primarily the result of our net income of \$10.7 million in the current year period, as well as our consistent collection of accounts receivable. Also, of the current period \$12.0 million of positive operating cash flow, \$1.6 million was due to the timing of our income tax payments and \$1.4 million was the result of tax credits from employee stock option exercises.

For the six-month period ended June 30, 2004, we generated \$11.9 million of positive operating cash flow. The positive cash flow was primarily due to our net income during the period and our accounts receivable collection performance. Additionally, our operating cash flow benefited during this period from a federal income tax overpayment carried over from 2003.

### **Investing Cash Flows:**

We used \$26.1 million in cash in investing activities during the six months ended June 30, 2005. Of this total, \$25.7 million was used to complete five business acquisitions during the period, with the majority of this expenditure occurring in the quarter ended June 30, 2005. We also used \$4.2 million to acquire equipment and other fixed assets, of which \$1.2 million was used to purchase a new software system for our specialty drug distribution business, \$1.5 million was used for infrastructure items such as furniture, fixtures and computer hardware, \$1.1 million was used to acquire revenue-generating medical equipment such as infusion pumps and other durable medical equipment, and \$400,000 was used for internally-developed software projects. During the six months ended June 30, 2005, we generated a net \$3.8 million in cash from the liquidation of short-term investments to help fund our acquisition payments.

In the prior year period ending June 30, 2004, we used \$3.7 million in investing activities. Of this total, we used \$1.1 million to acquire two small businesses and used \$2.6 million for the purchase of equipment and other fixed assets. Of this total, \$1.5 million was used to acquire infusion pumps and other revenue-generating medical equipment, \$600,000 was used for infrastructure improvement and \$500,000 was used on internally and externally developed software products.

### **Financing Cash Flows:**



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Financing activities generated a net \$3.2 million in positive cash flow during the six months ended June 30, 2005. We generated \$4.5 million in cash from issuance of shares of common stock to employees who exercised stock options or participated in our employee stock purchase plan, and we used \$1.1 million to pay cash dividends to our shareholders. We also used \$200,000 to pay trailing debt issuance costs related to our convertible debt offering from November 2004.

In the prior year period ending June 30, 2004, financing activities generated \$600,000 in cash flow. We generated \$2.4 million from employee stock option exercises and employee stock purchase plan contributions. This was offset by \$900,000 used to purchase treasury stock, \$400,000 used to pay a cash dividend to our common shareholders and \$400,000 used for scheduled debt repayments on capital leases and other fixed-rate debts.

### **Convertible Senior Notes:**

In November 1, 2004, we completed an \$86.3 million offering of 2.25% convertible senior notes, due 2024. The purpose of the offering was to finance our future growth initiatives. The funds may be used for acquisitions, stock repurchases, operating cash needs and other general corporate purposes. The initial offering was completed on November 2, 2004 for \$75.0 million, with an option for an additional \$11.3 million. This option was exercised in full on November 9, 2004. We will pay 2.25% interest per annum on the principal amount of the notes, payable semi-annually in arrears on May 1 and November 1 of each year, with the first payment due and paid on May 1, 2005. The holders may convert the notes into cash and, if applicable, shares of our common stock if certain

conversion criteria are met, such as our stock reaching a threshold market price or various other criteria. The notes cannot be redeemed by us prior to November 1, 2009. On each of November 1, 2009, November 1, 2014 and November 1, 2019, the holders can require us to purchase all or a portion of the outstanding notes for their principal amount plus accrued interest. At any time on or after November 1, 2009, we may redeem the notes, in whole or in part, at a redemption price equal to 100% of the principal amount, plus any accrued and unpaid interest. We have incurred deferred financing costs of \$3.2 million related to this offering, consisting of underwriting, legal and other related costs. These costs are being amortized straight-line over a five-year period.

**Accounts Receivable:**

The following table sets forth information regarding our accounts receivable as of the dates indicated (dollar amounts in thousands):

	<b>June 30, 2005</b>	<b>March 31, 2005</b>	<b>December 31, 2004</b>
Accounts receivable	\$ 78,614	\$ 80,029	\$ 76,809
Less allowance for doubtful accounts	(6,039)	(5,948)	(6,879)
Accounts receivable, net of allowance for doubtful accounts	\$ 72,575	\$ 74,081	\$ 69,930
Days sales outstanding (DSO)(1)	57 days	54 days	55 days

(1) DSO is based on trade accounts receivable, net of allowance for doubtful accounts, and is calculated using the exhaustion method whereby the net accounts receivable balance is exhausted against each preceding month's or partial month's net revenue. The DSO calculated above includes only our specialty pharmacy service line and infusion and related healthcare service line.

Our accounts receivable, net of bad debt reserves, was \$72.6 million as of June 30, 2005 compared to \$74.1 million at March 31, 2005 and \$69.9 million as of December 31, 2004. The quarterly decline in accounts receivable was primarily due to a seasonal decline in Synagis revenue which more than offset the increase related to same store sales growth and business acquisitions we completed during the quarter.

The following table sets forth the percentage breakdown of our trade accounts receivable by aging category and by major payor as of the dates indicated:

	<b>June 30, 2005</b>	<b>March 31, 2005</b>	<b>December 31, 2004</b>
<b><u>By Aging Category (1):</u></b>			
Aged 0-90 days	72%	74%	72%
Aged 91-180 days	15%	13%	13%
Aged 181-365 days	8%	8%	9%
Aged over 365 days	5%	5%	6%
Total	100%	100%	100%

**By Major Payor:**

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Managed care and other payors	80%	83%	82%
Medicare and Medicaid	20%	17%	18%
Total	100%	100%	100%

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(1) Accounts receivable by aging category considers only accounts of our specialty pharmacy service line and infusion and related healthcare service line.

Our days sales outstanding (DSO) increased to 57 days as of June 30, 2005 from 54 days as of March 31, 2005. This increase was due in part to normal fluctuations in the timing of payments received under our principal managed care contract with Blue Cross and Blue Shield of Florida.

As of June 30, 2005 we had cash and cash equivalents of \$8.9 million and short-term investments of \$71.6 million for a combined

total of \$80.5 million available for operations, acquisitions and other cash requirements. As of December 31, 2004, we had cash and cash equivalents of \$19.8 million and short-term investments of \$75.4 million for a combined total of \$95.2 million. The \$14.7 million decline in cash, cash equivalents and short-term investments was primarily due to acquisition activities, which used \$25.7 million in cash during the period. We generated positive cash flow from operations of \$12.0 million during the six months ended June 30, 2005, which partially offset our use of cash for acquisitions. We believe that cash flow from operations and our current reserves of cash and short-term investments will be sufficient to meet our operating cash needs for the immediate future, including any interest due on our \$86.3 million of 2.25% convertible senior notes. In the event that additional capital is required, there can be no assurance that such capital can be obtained from other sources on terms acceptable to us, if at all.

Our business strategy includes the selective acquisition of additional local pharmacy facilities and specialty pharmacy operations. Accordingly, we may require additional capital in order to complete these acquisitions. It is impossible to predict the amount of capital that may be required for acquisitions, and there is no assurance that sufficient financing for these activities will be available on terms acceptable to us, if at all.

### **Goodwill and Other Intangible Assets**

As of June 30, 2005, we had net goodwill and other intangible assets of \$86.0 million, consisting of \$85.3 million of goodwill and \$700,000 of other intangible assets such as non-competition agreements and managed care contracts. As of December 31, 2004, net goodwill and other intangible assets equaled \$65.9 million, consisting of \$65.4 million of goodwill and \$500,000 of other intangible assets. During the six months ended June 30, 2005, goodwill increased \$19.9 million as a result of the five business acquisitions we completed during the period. Other intangible assets increased by \$400,000 as a result of these acquisitions, offset by amortization of \$200,000 during the period.

As required by Statements of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets (SFAS No. 142)*, we do not amortize goodwill, but test our goodwill for impairment annually each October 1, or whenever we identify events or conditions that could potentially result in impairment of our goodwill. During the quarter ended June 30, 2005, no impairment of goodwill was identified.

### **Regulatory and Other Developments**

***Health Insurance Portability and Accountability Act of 1996 (HIPAA)***. To improve the efficiency and effectiveness of the health care system, the Health Insurance Portability and Accountability Act (HIPAA) of 1996, Public Law 104-191, included Administrative Simplification provisions that required the Department of Health and Human Services (HHS) to adopt national standards for electronic health care transactions. The Administrative Simplification provisions address electronic health care transactions and the security of electronic health information systems. Providers are required to comply with the standards by specific compliance dates established by HHS. For standards relating to electronic health care transactions, the compliance date was originally set for October 16, 2002. If the covered entity filed for an extension, the compliance date was postponed until October 16, 2003. The security standards applicable to individually identifiable health information maintained electronically were required to be implemented by April 21, 2005. We were materially compliant with these standards by the applicable compliance dates. The standards for a unique national health identifier for providers used in connection with electronic healthcare transactions must be implemented by May 23, 2007. We expect to be able to materially comply with this regulation by its applicable compliance date.

Penalties for non-compliance with the HIPAA Administrative Simplification provisions range from a civil penalty of \$100 for each violation (which can total up to \$25,000 per person per year), to criminal penalties, including up to \$50,000 and/or one year imprisonment, up to \$100,000 and/or five years imprisonment if the offense is committed under false pretenses and up to \$250,000 and/or ten years imprisonment for violating a standard with the intent to sell, transfer or use individually identifiable health information for commercial advantage, personal gain or malicious harm.

In addition to regulating privacy of individual health information and other provisions relating to Administrative Simplification, HIPAA includes several anti-fraud and abuse laws, extends criminal penalties to private health care benefit programs and, in addition to Medicare and Medicaid, to other federal health care programs, and expands the Office of Inspector General's authority to exclude persons and entities from participating in the Medicare and Medicaid programs.

*Medicare Prescription Drug, Improvement and Modernization Act of 2003.* The Medicare Prescription Drug, Improvement and Modernization Act of 2003 changed the way in which covered outpatient drugs are reimbursed by the Medicare program. In January 2004, payment for most drugs covered by Medicare decreased to 85% of the AWP for those drugs, determined as of April 1, 2003. Beginning in 2005, reimbursement for most Medicare Part B drugs not paid on a cost or prospective payment basis was to be set at either 106% of the average sales price (ASP) or through a competitive acquisition program to be phased in beginning in 2006. The competitive acquisition program will be established by the Centers for Medicare and Medicaid Services (CMS) and will enable physicians in designated competitive acquisition areas to purchase drugs through contractors that have successfully bid for that right. Each physician will elect annually whether to obtain drugs through the competitive acquisition program. CMS will re-bid the contracts at least every three years. A significant portion of the infusion drugs provided by us are administered in connection with covered durable medical equipment (DME). The payment rate for drugs administered in this manner generally will continue to be 95% of the AWP in effect as of October 1, 2003.

While the majority of our revenue is reimbursed by managed care organizations and other non-government payors, these changes to the way Medicare pays for outpatient drugs and biologicals may reduce our revenue and gross margins on services provided to Medicare patients. Further, adoption of ASP as the standard measure for determining reimbursement by state Medicaid programs for the drugs we provide may reduce our revenue and gross margins.

### **ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

We are subject to market risk primarily in relation to our cash and cash equivalents and short-term investments. As of June 30, 2005, we had no variable-rate debt. In November 2004, we completed an \$86.3 million offering of 2.25% convertible senior notes due 2024. The interest rate on this debt is fixed. However, the interest rate we may earn on the cash generated from this offering, as well as

cash generated from our operations, is subject to market fluctuations. We utilize a mix of investment maturities based on our anticipated cash needs and evaluation of existing interest rates and market conditions.

The following table sets forth our cash and cash equivalents and short-term investments as of the dates indicated (in thousands):

	June 30, 2005		March 31, 2005		December 31, 2004
Cash and cash equivalents (1)	\$ 8,860	\$	\$ 11,604	\$	\$ 19,816
Short-term investments (2)	71,598		85,814		75,370
Total	\$ 80,458	\$	97,418		95,186

- (1) Cash equivalents includes highly-liquid investments having a maturity of three months or less at time of purchase,
- (2) Short-term investments consist of commercial paper with maturities of three months or more at time of acquisition, as well as variable-rate municipal demand notes, preferred stocks and similar instruments that are either perpetual in nature or have final maturities greater than three months.

While we attempt to minimize market risk and maximize return, changes in market conditions may significantly affect the income we earn on our cash and cash equivalents and short-term investments. Based on our actual cash and cash equivalents and short-term investment balances at June 30, 2005, a 100 basis point decline in interest rates would reduce our interest income by \$805,000 on an annualized basis.

#### ITEM 4. Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) as of June 30, 2005. Based upon that evaluation, the chief executive officer and chief financial officer concluded that our disclosure controls and procedures are effective as of June 30, 2005. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

In addition, no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) occurred during our fiscal quarter ended June 30, 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

#### PART II. OTHER INFORMATION

**ITEM 1. Legal Proceedings**

We are subject to claims and legal actions that may arise in the ordinary course of business. However, we maintain insurance to protect against such claims or legal actions. We are not aware of any litigation, either pending or filed, that we believe is likely to have a material adverse effect on our results of operation or financial condition.

**ITEM 2. Unregistered Sales of Equity Securities**

Effective May 1, 2005, we acquired the outstanding stock of At Home Solutions, Inc., an independent infusion pharmacy provider operating in the major population centers of Montana. A portion of the purchase price will be paid in shares of our common stock. A total of 48,315 shares will be issued, valued at \$13.31 per share, pursuant to the exemption from registration provided Rule 506 of Regulation D and/or Section 4(2) of the Securities Act of 1933.

**ITEM 3. Defaults Upon Senior Securities**

None.

**ITEM 4. Submission of Matters to a Vote of Securities Holders**

We held our annual meeting of stockholders on May 9, 2005. At that meeting, our stockholders were asked to consider and vote upon the following matters.

1. Election of one member to the Board of Directors to hold office for a three-year term or until his successor is duly elected and qualified. The nominee, who was listed in our proxy statement, was elected for a three-year term, with the results of voting as follows:

	<b>VOTES FOR</b>	<b>VOTES AGAINST</b>	<b>ABSTAIN</b>
Leo Henikoff, M.D.	22,886,626	0	1,102,685

2. Ratification of the appointment of Ernst & Young, LLP as our independent auditors for the fiscal year 2005. The proxy voting results were as follows:

<b>VOTES FOR</b>	<b>VOTES AGAINST</b>	<b>ABSTAIN</b>
23,941,025	46,850	1,436

**ITEM 5. Other Information**

None.

**ITEM 6. Exhibits**

See Exhibit Index.



**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 9, 2005

OPTION CARE, INC.  
By: /s/ Paul Mastrapa  
*Chief Financial Officer*  
*(Principal Accounting Officer and Principal Financial Officer)*

**EXHIBIT INDEX**

**Exhibit  
Number**

- 3.1 Certificate of Incorporation of the Registrant, together with Certificate of Amendment thereto filed February 18, 1992. Filed as Exhibit 3(a) to Option Care's Registration Statement (No. 33-45836) dated April 15, 1992 and incorporated by reference herein.
- 3.2 Certificate of Amendment to Certificate of Incorporation of the Registrant filed March 25, 1992. Filed as Exhibit 3(c) to Option Care's Registration Statement (No. 33-45836) dated April 15, 1992 and incorporated by reference herein.
- 3.3 Certificate of Amendment to Certificate of Incorporation of the Registrant filed with the Delaware Secretary of State on June 18, 2002. Filed as Exhibit 3.3 to Option Care's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 and incorporated by reference herein.
- 3.4 Restated By-laws of the Registrant dated June 1, 1994. Filed as Exhibit 10.5 to Option Care's Annual Report on Form 10-K for the year ending December 31, 1994 and incorporated by reference herein.
- 4.1 Indenture Agreement by and among Option Care, Inc. and LaSalle Bank National Association, including the Form of our 2.25% Convertible Senior Notes due 2024. Filed as Exhibit 4.1 to our Current Report on Form 8-K filed on November 11, 2004 and incorporated by reference herein.
- 4.2 Registration Rights Agreement dated as of November 2, 2004 by and among Option Care, UBS Securities LLC and Piper Jaffray & Co. Filed as Exhibit 4.2 to our Current Report on Form 8-K filed on November 11, 2004 and incorporated by reference herein.
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Senior Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of Chief Executive Officer and Senior Vice President and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, and Rule 13a-14(b) of the Exchange Act.