

GENENTECH INC
Form 10-Q
August 03, 2005

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 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: 1-9813

GENENTECH, INC.

(Exact name of registrant as specified in its charter)

Delaware

94-2347624

(State or other jurisdiction
of incorporation or organization)

(I.R.S. Employer
Identification Number)

1 DNA Way, South San Francisco, California 94080-4990

(Address of principal executive offices and Zip Code)

(650) 225-1000

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [x] No []

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

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

| <u>Class</u> | <u>Number of Shares Outstanding</u> |
|-------------------------------|--|
| Common Stock \$0.02 par value | 1,064,282,776 Outstanding at July 21, 2005 |

GENENTECH, INC.
TABLE OF CONTENTS

| | <u>Page No.</u> |
|---------|--|
| | <u>PART I - FINANCIAL INFORMATION</u> |
| Item 1. | 3 |
| | <u>Financial Statements</u> |
| | 3 |
| | <u>Condensed Consolidated Statements of Income - for the three and six months ended June 30, 2005 and 2004</u> |
| | 4 |
| | <u>Condensed Consolidated Statements of Cash Flows - for the six months ended June 30, 2005 and 2004</u> |
| | 5 |
| | <u>Condensed Consolidated Balance Sheets - June 30, 2005 and December 31, 2004</u> |
| | 6 - 15 |
| | <u>Notes to Condensed Consolidated Financial Statements</u> |
| | 16 |
| | <u>Report of Independent Registered Public Accounting Firm</u> |
| Item 2. | 17 - 48 |
| | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> |
| Item 3. | 49 |
| | <u>Quantitative and Qualitative Disclosures About Market Risk</u> |
| Item 4. | 49 |
| | <u>Controls and Procedures</u> |
| | <u>PART II - OTHER INFORMATION</u> |

| | | |
|---------|--|----|
| Item 1. | <u>Legal Proceedings</u> | 50 |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 50 |
| Item 4. | <u>Submission of Matters to a Vote of Security Holders</u> | 51 |
| Item 6. | <u>Exhibits</u> | 51 |
| | <u>SIGNATURES</u> | 52 |

In this report, "Genentech," "we," "us" and "our" refer to Genentech, Inc. "Common Stock" refers to Genentech's common stock, par value \$0.02 per share, "Special Common Stock" refers to Genentech's callable puttable common stock, par value \$0.02 per share, all of which was redeemed by Roche Holdings, Inc. on June 30, 1999.

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

- 2 -

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

GENENTECH, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

(Unaudited)

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| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2005 | 2004 | 2005 | 2004 |
| Operating revenues | | | | |
| Product sales (including amounts from related parties: three months - 2005-\$28,234; 2004-\$27,668; six months - 2005-\$82,355; 2004-\$55,492) | \$ 1,274,115 | \$ 913,366 | \$ 2,460,117 | \$ 1,677,066 |
| Royalties (including amounts from related party: three months - 2005-\$107,199; 2004-\$84,071; six months - 2005-\$212,258; 2004-\$155,368) | 200,321 | 151,860 | 432,236 | 305,957 |
| Contract revenue (including amounts from related parties: three months - 2005-\$30,425; 2004-\$33,891; six months - 2005-\$56,885; 2004-\$70,512) | 52,443 | 62,852 | 96,104 | 120,190 |
| Total operating revenues | 1,526,879 | 1,128,078 | 2,988,457 | 2,103,213 |
| Costs and expenses | | | | |
| Cost of sales (including amounts for related parties: three months - 2005-\$38,826; 2004-\$26,019; six months - 2005-\$88,856; 2004-\$48,664) | 269,481 | 186,683 | 520,522 | 301,163 |
| Research and development (including amounts for related parties: three months - 2005-\$41,367; 2004-\$49,457; six months - 2005-\$82,078; 2004-\$88,818) (including contract related: three months - 2005-\$37,136; 2004-\$34,571; six months - 2005-\$63,711; 2004-\$71,495) | 278,124 | 212,886 | 521,364 | 403,231 |
| Marketing, general and administrative | 356,638 | 276,654 | 671,852 | 523,968 |
| Collaboration profit sharing (including amounts for related party: three months - 2005-\$28,727; 2004-\$14,827; six months - 2005-\$52,375; | 198,798 | 145,221 | 375,075 | 271,652 |

2004-\$26,649)

| | | | | |
|---|------------------|----------------|------------------|------------------|
| Recurring charges related to redemption | 34,482 | 38,209 | 68,964 | 76,418 |
| Special items: litigation-related | 19,527 | 13,458 | 30,784 | 26,857 |
| Total costs and expenses | 1,157,050 | 873,111 | 2,188,561 | 1,603,289 |
| Operating margin | 369,829 | 254,967 | 799,896 | 499,924 |
| Other income, net | 31,502 | 15,444 | 47,899 | 37,765 |
| Income before taxes | 401,331 | 270,411 | 847,795 | 537,689 |
| Income tax provision | 105,165 | 99,640 | 267,455 | 190,331 |
| Net income | \$ 296,166 | \$ 170,771 | \$ 580,340 | \$ 347,358 |
| Earnings per share | | | | |
| Basic | \$ 0.28 | \$ 0.16 | \$ 0.55 | \$ 0.33 |
| Diluted | \$ 0.27 | \$ 0.16 | \$ 0.54 | \$ 0.32 |
| Weighted-average shares used to compute earnings per share | | | | |
| Basic | 1,057,564 | 1,060,619 | 1,052,228 | 1,057,955 |
| Diluted | 1,083,841 | 1,087,087 | 1,076,519 | 1,084,618 |

See Notes to Condensed Consolidated Financial Statements

- 3 -

GENENTECH, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

| Six Months Ended June 30, | |
|------------------------------|------|
| 2005 | 2004 |

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| | | |
|---|------------------|------------------|
| Cash flows from operating activities | | |
| Net income | \$ 580,340 | \$ 347,358 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 181,454 | 178,516 |
| Deferred income taxes | (54,352) | (17,715) |
| Deferred revenue | (21,760) | (18,846) |
| Litigation-related liabilities | 25,712 | 25,712 |
| Tax benefit from employee stock options | 326,600 | 231,305 |
| Loss (gain) on sales of securities available-for-sale and other, net | 2,115 | (605) |
| Changes in assets and liabilities: | | |
| Receivables, prepaid expenses, and other current assets | (121,276) | (157,758) |
| Inventories | (10,520) | (58,009) |
| Investments in trading securities | (8,051) | (28,496) |
| Accounts payable, other accrued liabilities, and other long-term liabilities | (82,092) | (64,447) |
| Net cash provided by operating activities | 818,170 | 437,015 |
| Cash flows from investing activities | | |
| Purchases of securities available-for-sale | (313,468) | (684,109) |
| Proceeds from sales and maturities of securities available-for-sale | 398,576 | 624,227 |
| Capital expenditures | (729,810) | (196,633) |
| Change in other assets | (30,780) | (28,933) |
| Transfer to restricted cash | - | (52,000) |
| Net cash used in investing activities | (675,482) | (337,448) |
| Cash flows from financing activities | | |
| Stock issuances | 465,194 | 366,737 |
| Stock repurchases | (160,655) | (575,749) |
| Net cash provided by (used in) financing activities | 304,539 | (209,012) |
| Net increase (decrease) in cash and cash equivalents | 447,227 | (109,445) |
| Cash and cash equivalents at beginning of period | 270,123 | 372,152 |
| Cash and cash equivalents at end of period | \$ 717,350 | \$ 262,707 |
| Supplemental disclosure of cash flow information | | |
| Non-cash investing and financing activities | | |
| Capitalization of construction in progress related to financing lease transaction | \$ 73,000 | \$ - |

Exchange of XOMA note receivable for a prepaid royalty

29,205

-

See Notes to Condensed Consolidated Financial Statements.

- 4 -

GENENTECH, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

*(In thousands)**(Unaudited)*

| | June 30, 2005 | December 31, 2004 |
|---|----------------------|----------------------|
| Assets | | |
| Current assets | | |
| Cash and cash equivalents | \$ 717,350 | \$ 270,123 |
| Short-term investments | 1,293,191 | 1,394,982 |
| Accounts receivable -- product sales (net of allowances: 2005-\$65,854; 2004-\$59,366; including amounts from related parties: 2005-\$9,378; 2004-\$11,237) | 509,971 | 599,052 |
| Accounts receivable -- royalties (including amounts from related party: 2005-\$130,374; 2004-\$119,080) | 238,714 | 217,482 |
| Accounts receivable -- other (net of allowances: 2005-\$2,132; 2004-\$2,191; including amounts from related parties: 2005-\$93,989; 2004-\$68,594) | 165,133 | 140,838 |
| Inventories | 600,863 | 590,343 |
| Prepaid expenses | 196,985 | 45,864 |
| Other current assets | 213,598 | 164,073 |
| Total current assets | 3,935,805 | 3,422,757 |
| Long-term marketable debt and equity securities | 901,052 | 1,115,327 |
| Property, plant and equipment, net | 2,792,106 | 2,091,404 |
| Goodwill | 1,315,019 | 1,315,019 |
| Other intangible assets | 603,956 | 668,391 |
| Restricted cash and investments | 682,000 | 682,000 |
| Other long-term assets | 316,672 | 108,497 |
| Total assets | \$ 10,546,610 | \$ 9,403,395 |
| Liabilities and stockholders' equity | | |
| Current liabilities | | |

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| | | |
|---|---------------|--------------|
| Accounts payable | \$ 45,629 | \$ 104,832 |
| Taxes payable | - | 134,937 |
| Deferred revenue | 44,845 | 45,989 |
| Other accrued liabilities (including amounts to related parties: 2005-\$133,266; 2004-\$108,416) | 1,051,261 | 957,508 |
| Total current liabilities | 1,141,735 | 1,243,266 |
| Long-term debt | 485,250 | 412,250 |
| Deferred revenue | 247,192 | 267,805 |
| Litigation-related and other long-term liabilities | 692,428 | 697,884 |
| Total liabilities | 2,566,605 | 2,621,205 |
| Commitments and contingencies | | |
| Stockholders' equity | | |
| Preferred stock | - | - |
| Common stock | 21,248 | 20,943 |
| Additional paid-in capital | 8,773,117 | 8,002,754 |
| Accumulated other comprehensive income | 272,967 | 290,948 |
| Accumulated deficit, since June 30, 1999 | (1,087,327) | (1,532,455) |
| Total stockholders' equity | 7,980,005 | 6,782,190 |
| Total liabilities and stockholders' equity | \$ 10,546,610 | \$ 9,403,395 |

See Notes to Condensed Consolidated Financial Statements.

- 5 -

GENENTECH, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Summary of Significant Accounting Policies

Basis of Presentation

We prepared the condensed consolidated financial statements following the requirements of the Securities and Exchange Commission for interim reporting. As permitted under those rules, certain footnotes or other financial information that are normally required by accounting principles generally accepted in the United States of America (or "GAAP") can be condensed or omitted. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the consolidated financial statements and accompanying notes included in our Annual Report

on Form 10-K for the year ended December 31, 2004. In the opinion of management, the financial statements include all normal and recurring adjustments that are considered necessary for the fair presentation of our financial position and operating results.

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

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Genentech and all subsidiaries. Genentech also consolidates a variable interest entity in which Genentech is the primary beneficiary pursuant to Financial Accounting Standards Board (or "FASB") Interpretation No. 46 (or "FIN 46") "Consolidation of Variable Interest Entities," as amended, and recorded the noncontrolling interest in "litigation-related and other long-term liabilities" in the accompanying condensed consolidated balance sheets at June 30, 2005 and December 31, 2004. Material intercompany accounts and transactions have been eliminated.

Use of Estimates and Reclassifications

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

Certain reclassifications of prior period amounts have been made to our condensed consolidated financial statements to conform to the current period presentation.

Recent Accounting Pronouncements

In December 2004, the FASB issued a revision of Statement of Financial Accounting Standards (or "FAS") No. 123, "Accounting for Stock-Based Compensation." The revision is referred to as "FAS 123R -- Share-Based Payment", which supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," (or "APB 25") and will require companies to recognize compensation expense, using a fair-value based method, for costs related to share-based payments including stock options and stock issued under our employee stock plans. We expect to adopt FAS 123R using the modified prospective basis on January 1, 2006. We expect that our adoption of FAS 123R will result in compensation expense comparable to those disclosed below, before the effect of capitalization of manufacturing related compensation expenses. We are currently evaluating option valuation methodologies and assumptions in light of FAS 123R; the methodologies and assumptions we ultimately use to adopt FAS 123R may be different than those currently used as discussed below in "Accounting for Stock-Based Compensation" section of this note. We currently expect that our adoption of FAS 123R will have a material impact on our consolidated results of operations.

Accounting for Stock-Based Compensation

Until we adopt FAS 123R, we will continue to follow APB 25 to account for employee stock options. Under APB 25, the intrinsic value method of accounting, no compensation expense is recognized because the exercise price of our employee stock options equals the market price of the underlying stock on the date of grant. We apply FAS 123 for disclosure purposes only.

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The following proforma net income and earnings per share were determined as if we had accounted for our employee stock options and stock issued under our employee stock plan under the fair value method prescribed by FAS 123. The resulting effect on net income and earnings per share pursuant to FAS 123 is not likely to be representative of the effects in future periods, due to subsequent additional option grants and periods of vesting.

The Black-Scholes option valuation model was developed for use in estimating the fair value of publicly traded options, which have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions and these assumptions can vary over time. Because our employee stock options and stock plan shares have characteristics significantly different from those of traded options, and changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing valuation models do not provide a single reliable measure of the fair value of our employee stock options.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------|------------------------------|------------|
| | 2005 | 2004 | 2005 | 2004 |
| (In thousands, except per share amounts) | | | | |
| Net income - as reported | \$ 296,166 | \$ 170,771 | \$ 580,340 | \$ 347,358 |
| Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects | 41,033 | 45,611 | 81,422 | 90,316 |
| Pro forma net income | \$ 255,133 | \$ 125,160 | \$ 498,918 | \$ 257,042 |
| Earnings per share: | | | | |
| Basic-as reported | \$ 0.28 | \$ 0.16 | \$ 0.55 | \$ 0.33 |
| Basic-pro forma | \$ 0.24 | \$ 0.12 | \$ 0.47 | |