STERIS CORP
Form 10-Q
February 08, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q
(Mark One)

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

For the quarterly period ended December 31, 2012

or

o 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 1-14643

STERIS Corporation
(Exact name of registrant as specified in its charter)

Ohio (State or other jurisdiction of incorporation or organization)	34-1482024 (IRS Employer Identification No.)
5960 Heisley Road, Mentor, Ohio (Address of principal executive offices)	44060-1834 (Zip code)

440-354-2600
(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 x No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer x	Accelerated Filer o
Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company o

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

The number of common shares outstanding as of January 31, 2013: 58,465,549

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PART 1—FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STERIS CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31, 2012 (Unaudited)	March 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$155,887	$150,821
Accounts receivable (net of allowances of $9,511 and $11,428, respectively)	248,021	280,324
Inventories, net	163,577	157,712
Deferred income taxes, net	16,235	43,211
Prepaid expenses and other current assets	38,413	19,815
Total current assets	622,133	651,883
Property, plant, and equipment, net	425,550	386,409
Goodwill and intangibles, net	709,950	337,784
Other assets	7,439	29,620
Total assets	$1,765,072	$1,405,696
Liabilities and equity		
Current liabilities:		
Accounts payable	$78,169	$83,188
Accrued payroll and other related liabilities	49,901	29,899
Accrued SYSTEM 1 Rebate Program and class action settlement	5,549	69,065
Accrued expenses and other	94,189	96,243
Total current liabilities	227,808	278,395
Long-term indebtedness	520,890	210,000
Deferred income taxes, net	37,917	42,703
Other liabilities	58,263	51,934
Total liabilities	$844,878	$583,032
Commitments and contingencies (see note 10)		
Serial preferred shares, without par value; 3,000 shares authorized; no shares issued or outstanding	—	—
Common shares, without par value; 300,000 shares authorized; 70,040 shares issued; 58,416 and 57,733 shares outstanding, respectively	240,850	244,091
Common shares held in treasury, 11,624 and 12,307 shares, respectively	(332,782)	(350,718)
Retained earnings	1,000,952	914,401
Accumulated other comprehensive income	10,100	13,627
Total shareholders' equity	919,120	821,401
Noncontrolling interest	1,074	1,263
Total equity	920,194	822,664
Total liabilities and equity	$1,765,072	$1,405,696

See notes to consolidated financial statements.

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STERIS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)
(Unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2012	2011	2012	2011
Revenues:				
Product	$243,722	$239,403	$689,125	$664,918
Service	136,683	115,812	384,561	351,643
Total revenues	380,405	355,215	1,073,686	1,016,561
Cost of revenues:				
Product	139,683	145,976	392,311	402,214
Service	87,600	71,233	237,880	210,107
Total cost of revenues	227,283	217,209	630,191	612,321
Gross profit	153,122	138,006	443,495	404,240
Operating expenses:				
Selling, general, and administrative	75,953	73,922	236,767	227,583
Research and development	10,415	9,196	29,579	26,867
Restructuring expenses	(386)	1,164	(570)	1,522
Total operating expenses	85,982	84,282	265,776	255,972
Income from operations	67,140	53,724	177,719	148,268
Non-operating expenses, net:				
Interest expense	4,207	3,005	10,586	9,083
Interest income and miscellaneous expense	(338)	(373)	(629)	(948)
Total non-operating expenses, net	3,869	2,632	9,957	8,135
Income before income tax expense	63,271	51,092	167,762	140,133
Income tax expense	15,174	17,443	49,166	48,189
Net income	$48,097	$33,649	$118,596	$91,944
Net income per common share				
Basic	$0.82	$0.58	$2.04	$1.57
Diluted	$0.82	$0.58	$2.02	$1.55
Cash dividends declared per common share outstanding	$0.19	$0.17	$0.55	$0.49

See notes to consolidated financial statements.

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STERIS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)
(Unaudited)

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2012	2011	2012	2011
Net income	$48,097	$33,649	118,596	91,944
Unrealized gain (loss) on available for sale securities	(3)	132	(20)	(122)
Amortization of pension and postretirement benefit plans costs, net of taxes	(184)	(269)	(543)	(809)
Change in cumulative foreign currency translation adjustment	2,269	(9,823)	(2,964)	(23,776)
Total other comprehensive income (loss)	2,082	(9,960)	(3,527)	(24,707)
Comprehensive income	$50,179	$23,689	$115,069	$67,237

See notes to consolidated financial statements.

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STERIS CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	Nine Months Ended December 31,	
	2012	2011
Operating activities:		
Net income	$118,596	$91,944
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion, and amortization	48,508	46,288
Deferred income taxes	22,064	22,758
Share-based compensation expense	6,353	5,799
Loss on the disposal of property, plant, equipment, and intangibles, net	292	376
Other items	(211)	(1,595)
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable, net	52,889	20,019
Inventories, net	10,065	(2,404)
Other current assets	(17,366)	(6,954)
Accounts payable	(13,397)	(21,127)
Accrued SYSTEM 1 Rebate Program and class action settlement	(63,516)	(27,449)
Accruals and other, net	16,659	(14,816)
Net cash provided by operating activities	180,936	112,839
Investing activities:		
Purchases of property, plant, equipment, and intangibles, net	(63,878)	(54,238)
Proceeds from the sale of property, plant, equipment, and intangibles	29	—
Acquisition of business, net of cash acquired	(399,415)	(22,269)
Net cash used in investing activities	(463,264)	(76,507)
Financing activities:		
Proceeds from the issuance of long-term obligations	100,000	—
Proceeds under credit facilities, net	210,890	—
Deferred financing fees and debt issuance costs	(1,581)	—
Repurchases of common shares	(7,893)	(56,751)
Cash dividends paid to common shareholders	(32,045)	(28,751)
Stock option and other equity transactions, net	14,517	3,749
Tax benefit from stock options exercised	2,161	816
Net cash provided by (used in) financing activities	286,049	(80,937)
Effect of exchange rate changes on cash and cash equivalents	1,345	(4,624)
Increase (decrease) in cash and cash equivalents	5,066	(49,229)
Cash and cash equivalents at beginning of period	150,821	193,016
Cash and cash equivalents at end of period	$155,887	$143,787

See notes to consolidated financial statements.

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STERIS CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
For the Three and Nine Months Ended December 31, 2012 and 2011
(dollars in thousands, except per share amounts)

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

STERIS Corporation, an Ohio corporation, develops, manufactures and markets infection prevention, contamination control, microbial reduction, and surgical and critical care support products and services for healthcare, pharmaceutical, scientific, research, industrial, and governmental Customers throughout the world. As used in this Quarterly Report, STERIS Corporation and its subsidiaries together are called “STERIS,” the “Company,” “we,” “us,” or “our, unless otherwise noted.

We operate in three reportable business segments: Healthcare, Life Sciences, and STERIS Isomedix Services (“Isomedix”). We describe our business segments in note 11 to our consolidated financial statements titled, “Business Segment Information.” Our fiscal year ends on March 31. References in this Quarterly Report to a particular “year” or “year-end” mean our fiscal year. The significant accounting policies applied in preparing the accompanying consolidated financial statements of the Company are summarized below:

Interim Financial Statements

We prepared the accompanying unaudited consolidated financial statements of the Company according to accounting principles generally accepted in the United States (“U.S. GAAP”) for interim financial information and the instructions to the Quarterly Report on Form 10-Q and Rule 10-01 of Regulation S-X. This means that they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. Our unaudited interim consolidated financial statements contain all material adjustments (including normal recurring accruals and adjustments) management believes are necessary to fairly state our financial condition, results of operations, and cash flows for the periods presented.

These interim consolidated financial statements should be read together with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended March 31, 2012 dated May 29, 2012. The Consolidated Balance Sheet at March 31, 2012 was derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

Principles of Consolidation

We use the consolidation method to report our investment in our subsidiaries. Therefore, the accompanying consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries. We eliminate inter-company accounts and transactions when we consolidate these accounts.

Use of Estimates

We make certain estimates and assumptions when preparing financial statements according to U.S. GAAP that affect the reported amounts of assets and liabilities at the financial statement dates and the reported amounts of revenues and expenses during the periods presented. These estimates and assumptions involve judgments with respect to many factors that are difficult to predict and are beyond our control. Actual results could be materially different from these estimates. We revise the estimates and assumptions as new information becomes available. This means that operating results for the three and nine month periods ended December 31, 2012 are not necessarily indicative of results that may be expected for future quarters or for the full fiscal year ending March 31, 2013.

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Recently Adopted Accounting Pronouncements

In June 2011, the FASB issued an accounting standard update titled "Presentation of Comprehensive Income," amending Accounting Standards Codification ASC Topic 220, "Comprehensive Income." This guidance requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This guidance became effective retrospectively for the interim periods and annual periods beginning after December 15, 2011; however, the FASB agreed to an indefinite deferral of the reclassification requirement as defined in accounting standard update titled "Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income," issued in December 2011. As required by the standard, Consolidated Statements of Comprehensive Income have been presented. The adoption of this standard did not have an impact on our consolidated financial position, results of operations or cash flows.

In July 2012, the FASB issued an accounting standards update titled "Testing Indefinite-Lived Intangible Assets for Impairment," amending certain sections of Subtopic 350-30 Intangibles-Goodwill and Other-General Intangibles Other than Goodwill. This amended guidance allows an entity to first assess qualitative factors to determine if it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount. If based on its qualitative assessment an entity concludes it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount, quantitative impairment testing is required. However, if an entity concludes otherwise, quantitative impairment testing is not required. The standards update is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, with early adoption permitted. The anticipated adoption of this standard is not expected to impact our consolidated financial position, results of operations or cash flows.

Significant Accounting Policies

A detailed description of our significant and critical accounting policies, estimates, and assumptions is included in our consolidated financial statements included in our Annual Report on Form 10-K for the year ended March 31, 2012 dated May 29, 2012. Our significant and critical accounting policies, estimates, and assumptions have not changed materially from March 31, 2012 with the exception of the estimates associated with the SYSTEM 1 Rebate Program and class action settlement.

SYSTEM 1 Rebate Program and Class Action Settlement

The SYSTEM 1 Rebate Program (the "Rebate Program") was initially recognized during the first quarter of fiscal 2011. The rebate portion of the Rebate Program was recognized as contra-revenue consistent with other returns and allowances offered to Customers. The estimated costs to facilitate the disposal of the returned SYSTEM 1 processors portion of the Rebate Program were recognized as cost of revenues. Both components are recorded as current liabilities. The key assumptions involved in the estimates associated with the Rebate Program included: the number and age of SYSTEM 1 processors eligible for rebates under the Rebate Program, the number of Customers that would elect to participate in the Rebate Program, the proportion of Customers that would choose each rebate option, and the estimated per unit costs of disposal.

The Rebate Program ended August 2, 2012. Through December 31, 2012, Customers have utilized or committed to utilize rebates totaling approximately $66,600 on orders placed since the initiation of the Rebate Program. Additional Customer orders utilizing rebates are not anticipated although exceptions can be made at the discretion of the Company and existing orders may be modified or canceled by Customers. Remaining disposal costs are based on the actual costs experienced to date.

During the second quarter of fiscal 2013, we adjusted the liability related to the Rebate Program. The total pre-tax adjustment was $21,500, of which $20,400 was recorded as an increase to revenue for the Customer rebate portion, and $1,100 was recorded as a reduction to cost of revenues related to the disposal portion of the liability. This adjustment resulted primarily from a lower number of eligible Customers electing to participate in the Rebate Program than previously estimated. The remaining recorded accrual is $4,312 as of December 31, 2012.

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The SYSTEM 1 class action settlement was initially recognized during the third quarter of fiscal 2011. The claim submission deadline was December 31, 2012. As a result during the third quarter of fiscal 2013, we adjusted the liability related to the SYSTEM 1 class action settlement. The pretax adjustment of $15,800, was recorded as a reduction to operating expenses. The remaining recorded accrual is $1,237 as of December 31, 2012 and is based on actual claims submitted through December 31, 2012.

2. Restructuring

The following summarizes our restructuring plans announced in prior fiscal years. We recognize restructuring expenses as incurred. In addition, we assess the property, plant and equipment associated with the related facilities for impairment. Additional information regarding our restructuring plans is included in our Annual Report on Form 10-K for the year ended March 31, 2012 dated May 29, 2012.

Fiscal 2010 Restructuring Plan

During the fourth quarter of fiscal 2010 we adopted a restructuring plan primarily related to the transfer of the remaining operations in our Erie, Pennsylvania facility to the U.S. headquarters in Mentor, Ohio and the consolidation of our European Healthcare manufacturing operations into two central locations within Europe (the “Fiscal 2010 Restructuring Plan”). In addition, we rationalized certain products and eliminated certain positions.

Since the inception of the Fiscal 2010 Restructuring Plan, we have incurred pre-tax expenses totaling $8,171 related to these actions, of which $7,065 was recorded as restructuring expenses and $1,106 was recorded in cost of revenues. We do not expect to incur any significant additional restructuring expenses related to this plan. These actions are intended to enhance profitability and improve efficiencies.

The following table summarizes our total pre-tax restructuring expenses for the third quarter of fiscal 2013 and fiscal 2012:

	Fiscal 2010 Restructuring Plan	
Three Months Ended December 31,	2012	2011 (1)
Severance and other compensation related costs	$(386)	$7
Asset impairment and accelerated depreciation	—	1,157
Lease termination obligation and other	—	3
Total restructuring charges	$(386)	$1,167

(1) Includes $3 in charges recorded in cost of revenues on Consolidated Statements of Income for fiscal 2012.

The following table summarizes our total pre-tax restructuring expenses for the first nine months of fiscal 2013 and fiscal 2012:

	Fiscal 2010 Restructuring Plan		Fiscal 2008 Restructuring Plan		Total	
Nine Months Ended December 31,	2012	2011 (1)	2012	2011	2012	2011 (1)
Severance and other compensation related costs	$(553)	$(73)	$—	$—	$(553)	$(73)

Product rationalization	—	335	—	—	—	335
Asset impairment and accelerated depreciation	(17)	1,341	—	—	(17)	1,341
Lease termination obligation and other	—	3	—	(152)	—	(149)
Total restructuring charges	$(570)	$1,606	$—	$(152)	$(570)	$1,454

(1) Includes $(68) in charges recorded in cost of revenues on Consolidated Statements of Income for fiscal 2012.

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Liabilities related to restructuring activities are recorded as current liabilities on the accompanying Consolidated Balance Sheets within “Accrued payroll and other related liabilities” and “Accrued expenses and other.” The following table summarizes our liabilities related to these restructuring activities:

	Fiscal 2010 Restructuring Plan			
		Fiscal 2013		
	March 31, 2012	Provision (1)	Payments/ Impairments (2)	December 31, 2012
Severance and termination benefits	$659	$(553)	$326	$432
Asset impairments and accelerated depreciation	—	(17)	17	—
Lease termination obligations	947	—	(791)	156
Other	76	—	(76)	—
Total	$1,682	$(570)	$(524)	$588

(1) Includes curtailment benefit of $495 related to International defined benefit plan. Additional information is included in note 9, "Benefit Plans."
(2) Certain amounts reported include the impact of foreign currency movements relative to the U.S. dollar.

3. Property, Plant and Equipment

Information related to the major categories of our depreciable assets is as follows:

	December 31, 2012	March 31, 2012
Land and land improvements (1)	$36,129	$33,099
Buildings and leasehold improvements	238,010	230,823
Machinery and equipment	318,912	301,665
Information systems	94,094	110,130
Radioisotope	233,564	210,899
Construction in progress (1)	43,396	22,811
Total property, plant, and equipment	964,105	909,427
Less: accumulated depreciation and depletion	(538,555)	(523,018)
Property, plant, and equipment, net	$425,550	$386,409

(1) Land is not depreciated. Construction in progress is not depreciated until placed in service.

4. Business Acquisitions

United States Endoscopy Group, Inc.
In August 2012, we completed the acquisition of all the outstanding shares of capital stock of United States Endoscopy Group, Inc. (“US Endoscopy”) pursuant to a Stock Purchase Agreement dated July 16, 2012 with US Endoscopy and its shareholders. The purchase price was approximately $270,000, plus a working capital adjustment of $2,145, which was paid during the third quarter of fiscal year 2013. In addition, we purchased all real estate used in the US Endoscopy business for approximately $7,000, including properties owned by two US Endoscopy affiliates. We did not assume any existing debt in connection with the purchases. The purchases were financed by a combination of cash on hand and borrowings under our existing credit facility. US Endoscopy will be integrated into the Healthcare

segment.

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The following table summarizes the allocation of the purchase price to the net assets acquired based on fair values at the acquisition date.

Cash	$767	
Accounts receivable	8,291	
Inventory	7,228	
Property, plant and equipment	12,457	
Other assets	913	
Intangible assets	144,000	
Goodwill	111,261	
Total assets acquired	284,917	
Accounts payable	(2,167	)
Other liabilities	(3,243	)
Total liabilities assumed	(5,410	)
Net assets acquired	$279,507	

We recorded acquisition related costs of $3,788, before tax, which are reported in selling, general and administrative expenses. We anticipate that the acquisition will qualify for a joint election tax benefit under Section 338(h)(10) of the Internal Revenue Code, which allows goodwill and intangibles to be fully deductible for tax purposes. The intangible assets acquired consist of trademarks, trade names and developed technologies, which will be amortized on a straight line basis over thirteen to fifteen years, with the exception of the US Endoscopy trade name which has an as indefinite life.

The Consolidated Financial Statements include the operating results of US Endoscopy from the date of acquisition. Pro-forma results of operations for fiscal 2013 and 2012 periods have not been presented because the effects of the acquisition were not material to our financial results.

Spectrum Surgical Instruments Corp and Total Repair Express

In October 2012, we purchased two privately-owned businesses: Spectrum Surgical Instruments Corp ("Spectrum") and Total Repair Express ("TRE"), providers of surgical instrument repair services and instrument care products to hospitals and surgery centers in the United States. The aggregate purchase price of approximately $110,000, including contingent consideration, was financed with borrowings under the existing credit facility. The instrument repair business will be integrated into the Healthcare business segment.

The following table summarizes the preliminary allocation of the purchase price to the net assets acquired in the Spectrum and TRE acquisitions, based on fair values at the acquisition date. The purchase price will be finalized after settlement of working capital adjustments and finalization of valuation analyses.

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For the Three and Nine Months Ended December 31, 2012 and 2011
(dollars in thousands, except per share amounts)

Cash	$424	
Accounts receivable	11,568	
Inventory	5,107	
Property, plant and equipment	5,145	
Other assets	295	
Intangible assets	41,500	
Goodwill	50,529	
Total assets acquired	114,568	
Accounts payable	(5,052	)
Other liabilities	(3,460	)
Total liabilities assumed	(8,512	)
Net assets acquired	$106,056	

We recorded acquisition related costs of $1,880, before tax, which are reported in selling, general and administrative expenses. We anticipate that the acquisition of Spectrum will qualify for a joint election tax benefit under Section 338(h)(10) of the Internal Revenue Code, which allows goodwill and intangibles to be fully deductible for tax purposes. The intangible assets acquired consist of trademarks, customer relationships and non-complete arrangements, which will be amortized on a straight line basis over one to fifteen years.

The Consolidated Financial Statements include the operating results of Spectrum and TRE from the date of acquisition. Pro-forma results of operations for fiscal 2013 and 2012 periods have not been presented because the effects of the acquisition were not material to our financial results.

VTS Medical Systems, LLC

In December 2012, we purchased the remaining interests in our VTS Medical Systems, LLC ("VTS") joint venture. The joint venture began in fiscal 2009, and we increased our ownership of the joint venture to just under 50% during fiscal 2011. With this final investment, VTS is now a wholly-owned subsidiary of STERIS and will be integrated into the Healthcare business segment. We purchased the remaining interests for a total of approximately $19,000, comprised of cash at closing and deferred cash payments to be paid over a ten year period.

We consolidated VTS for the first time in the third quarter of fiscal 2013. The following table summarizes the net assets included in the December 31, 2012 consolidated balance sheet including the preliminary allocation of the purchase price based on estimated fair values at the closing date. The consolidation had no impact on the consolidated statements of income for the period ended December 31, 2012. Valuations of the assets acquired and the equity interest held prior to the closing date are in process. Upon completion, the gain or loss on remeasurement to fair value of the equity interest will be recognized and the allocation of purchase price will be finalized.

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