INVACARE CORP
Form 10-Q
August 07, 2017

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

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

For the quarterly period ended June 30, 2017

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 001-15103

INVACARE CORPORATION

(Exact name of registrant as specified in its charter)

Ohio	95-2680965
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
One Invacare Way, Elyria, Ohio	44035
(Address of principal executive offices)	(Zip Code)

(440) 329-6000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 (the “Exchange Act”) 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 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 ¨

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 “small reporting company” in Rule 12b-2 of the Exchange Act. (Check One): Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ (Do not check if a smaller reporting company) Smaller reporting company ¨ Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

As of August 3, 2017, the registrant had 32,852,207 Common Shares and 18,357 Class B Common Shares outstanding.

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About Invacare Corporation

Invacare Corporation (NYSE: IVC) is a leading manufacturer and distributor in its markets for medical equipment used in non-acute care settings. At its core, the company designs, manufactures and distributes medical devices that help people to move, breathe, rest and perform essential hygiene. The company provides medical device solutions for congenital (e.g., cerebral palsy, muscular dystrophy, spina bifida), acquired (e.g., stroke, spinal cord injury, traumatic brain injury, post-acute recovery, pressure ulcers) and degenerative (e.g., ALS, multiple sclerosis, chronic obstructive pulmonary disease (COPD), elderly, bariatric) ailments. The company's products are important parts of care for people with a wide range of challenges, from those who are active and heading to work or school each day and may need additional mobility or respiratory support, to those who are cared for in residential care settings, at home and in rehabilitation centers. The company sells its products principally to home medical equipment providers with retail and e-commerce channels, residential care operators, dealers and government health services in North America, Europe and Asia/Pacific. For more information about the company and its products, visit Invacare's website at www.invacare.com.

MD&A Overview

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

The discussion and analysis presented below is concerned with material changes in financial condition and results of operations between the periods specified in the condensed consolidated balance sheet at June 30, 2017 and December 31, 2016, and in the condensed consolidated statement of comprehensive income (loss) for the three and six months ended June 30, 2017 and June 30, 2016. All comparisons presented are with respect to the same period last year, unless otherwise stated. This discussion and analysis should be read in conjunction with the consolidated financial statements and accompanying notes that appear elsewhere in this quarterly report on Form 10-Q and the MD&A included in the company's annual report on Form 10-K for the year ended December 31, 2016.

OVERVIEW

Strategy

For its first 35 years, the company had a strategy to be a leading provider of durable medical equipment to providers in global markets by providing the broadest portfolio available. This strategy had not kept pace with certain reimbursement changes, competitive dynamics and company-specific challenges, especially in the United States market. Since 2015, the company has made a major shift in its strategy to align its resources to produce products and solutions that assist customers and end-users with their most clinically complex needs. By focusing the company’s efforts to provide the best possible assistance and outcomes to the people and caregivers who use its products, the company aims to improve its financial condition for sustainable profit and growth. To execute this transformation, the company is undertaking a substantial three-phase, multi-year transformation plan.

Transformation

The company has been executing a multi-year transformation to shift to its new strategy, especially in North America. This is expected to yield better financial results from the application of the company’s resources to products and solutions that provide greater healthcare value in clinically complex rehabilitation and post-acute care. The transformation is divided into the following three phases:

Phase One - Assess and Reorient
- Increase commercial effectiveness;
- Shift and narrow the product portfolio;
- Align innovation resources to clinically complex solutions;
- Accelerate quality efforts with culture of quality excellence; and
- Develop and expand talent.

Phase One, which is largely complete in North America, was strategic alignment and investment phase with significant shifts in the mix of the company's business. During Phase One, the company made investments in SG&A, including hiring and training over 50% new North America/HME clinical sales representatives, mainly in 2016. The company reduced net sales of less accretive

product, including reducing net sales of aids for daily living, divested its Garden City Medical, Inc. (GCM) subsidiary, and discontinued non-core product categories such as consumer power wheelchairs in North America/HME. During Phase One, the North America/HME business also demonstrated gross margin percentage improvement through a more clinical mix of products from the integration of clinical subsidiaries, as well as an enhanced new product pipeline.

Phase Two - Build and Align
- Leverage commercial improvements;
- Optimize the business for cost and efficiency;
- Continue to improve quality systems;
- Launch new clinical product platforms; and
- Expand talent management and culture.

The company is currently in Phase Two of the transformation, focused on North America. By the end this phase, the company expects growth in sales and gross profit dollars, as well as an improvement in operating income and free cash flow. This is expected to come from the commercial execution of phase one investments and new product launches. The company also is optimizing its infrastructure and improving efficiencies. During the second quarter of 2017, the company took announced actions expected to yield $6.7 million in annualized cost savings, which is in addition to the previously announced $9.2 million of restructuring actions taken since October 2016.

Phase Three - Grow
- Lead in quality culture and operations excellence; and
- Grow above market.

By the end of phase three, the company expects continued improvements in net sales, operating margin, operating income and free cash flow.

Through the first half of 2017, the company expected continued lower net sales offset by favorable sales mix shift and increased gross margin as a percentage of net sales. In the second quarter of 2017, consolidated net sales decreased compared to the

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same period prior year, and sequentially decreased slightly compared to the first quarter of 2017. Gross margin as a percentage of net sales improved as a result of lower warranty costs and the strategic mix shift toward clinically complex products.

In the second quarter of 2017, the company issued $120,000,000 aggregate principal amount of 4.50% Convertible Senior Notes due 2022 in a private offering, and entered into related convertible note hedge and warrant transactions. Proceeds of the offering may be used to fund portions of the transformation and strengthen the company's working capital. For further information, see "Long-Term Debt" in the Notes to the Consolidated Financial Statements included elsewhere in this report.

The company expects to take advantage of opportunities for growth across its many product lines and businesses by providing clinical solutions to the growing demographic in need of the company's products. The company also remains focused on building an enterprise-wide quality culture, which it believes will ultimately be a competitive advantage. The company intends to move forward with its transformation, while managing through external uncertainty, such as changes in payor reimbursement policies. The company has demonstrated some improvements in the key short-term metrics as a result of its strategic shift. However, in spite of this, there may be interim periods where the company's investments do not fully yield expected financial improvements, particularly in light of various external factors.

STATUS OF THE CONSENT DECREE

On July 24, 2017, the company received notice from the United States Food and Drug Administration (FDA) that the company had satisfied the Agency's requirements under the consent decree to resume full operations at its Corporate and Taylor Street manufacturing facility in Elyria, Ohio. As a result, the company then became able to produce and sell all products made in the Taylor Street facility without the previous restrictions under the consent decree, which has been in effect since December 21, 2012.

The company is now able to sell its wheelchairs designed and manufactured at the Taylor Street facility without having to obtain the verification of medical necessity (VMN) documentation previously required under the consent decree. To ensure the facilities are in continuous compliance with FDA regulations and the consent decree, the consent decree requires the company to undergo five years of audits by a third-party auditor selected by Invacare. The third-party auditor will inspect the Corporate and Taylor Street facilities every six months for the first year, and then once every 12 months for the four years thereafter. Other Invacare manufacturing facilities were unaffected by the consent decree and have remained fully operational.

For a complete description of the consent decree, see the "Contingencies" note to the financial statements contained in Item

1 of this Quarterly Report on Form 10-Q and "Forward-Looking Statements" contained below in this Item.

OUTLOOK

The company is focused on transforming its business, especially in North America. Through the second half of 2017, the company should start to stabilize sales sequentially in its North America businesses through new product and service offerings, and increased productivity from its new commercial salesforce. The launch of the new Invacare® TDX® SP2 power wheelchair with LiNX® technology and the ability to sell power and manual wheelchairs from the Taylor Street facility without the previous restrictions from the consent decree are unlikely to have a material impact on the business until at least 2018 due to the time it takes to earn that business combined with the industry's extended

quote-to-order process. The quote-to-order process can delay the successful conversion of sales quotes to shipments between 60-90 days.

The company will continue its focus on reducing costs and improving efficiencies. The company's priorities remain: emphasizing a culture of quality excellence and achieving its long-term earnings potential. The company remains committed to its long-term earnings objective, which is largely based upon four parts:

•Net sales growth in North America/HME mobility and seating segment;
•Net sales growth in the IPG post-acute care business;
•Cost reductions across the North America businesses; and
•Continued net sales growth and efficiency gains in Europe.

Because of the scope and magnitude of changes being undertaken and the realized and potential changes affecting the business, the company expects some variation in the timing and relative magnitude of these results.

MD&A Results of Operations

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RESULTS OF OPERATIONS

On September 30, 2016, the company completed the sale of its subsidiary, Garden City Medical Inc. ("GCM"), to Compass Health Brands. GCM, doing business as PMI and Pinnacle Medsource, sourced and distributed primarily single-use products under the brand ProBasics™ by PMI. GCM was part of the North America/Home Medical Equipment (NA/HME) segment. This divestiture further refined the company's focus on other lines of business where the company's resources can best generate returns in areas of complex rehabilitation and post-acute care. CGM was not deemed a discontinued operation for financial reporting purposes, and therefore is included in the results below unless otherwise noted. For more information, see the condensed consolidated financial statements included in this Quarterly Report on Form 10-Q.

References herein to "year-to-date" refer to the first six months of the fiscal year, ended June 30.

MD&A Net Sales

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NET SALES

($ in thousands USD)	Q2 17	Q2 16	Reported % Change	Foreign Exchange % Impact	Constant Currency % Change
Europe	128,485	135,735	(5.3)	(5.5)	0.2
NA/HME	77,689	110,700	(29.8)	(0.3)	(29.5)
IPG	15,320	16,115	(4.9)	(0.1)	(4.8)
Asia/Pacific	12,023	12,487	(3.7)	0.6	(4.3)
Consolidated	233,517	275,037	(15.1)	(2.8)	(12.3)
NA/HME less divested GCM	77,689	101,636	(23.6)	(0.4)	(23.2)
Consolidated less divested GCM	233,517	265,973	(12.2)	(2.9)	(9.3)

($ in thousands USD)	YTD Q2 17	YTD Q2 16	Reported % Change	Foreign Exchange % Impact	Constant Currency % Change
Europe	247,993	257,766	(3.8)	(5.4)	1.6
NA/HME	161,951	218,372	(25.8)	—	(25.8)
IPG	31,693	34,359	(7.8)	(0.1)	(7.7)
Asia/Pacific	23,603	22,092	6.8	2.3	4.5
Consolidated	465,240	532,589	(12.6)	(2.5)	(10.1)
NA/HME less divested GCM	161,951	200,149	(19.1)	(0.1)	(19.0)
Consolidated less divested GCM	465,240	514,366	(9.6)	(2.7)	(6.9)

For the quarter, constant currency net sales increased in the European segment but was more than offset by declines in the NA/HME, IPG and Asia/Pacific segments.

Year-to-date constant currency net sales increased in the European and Asia/Pacific segments but was more than offset by declines in the NA/HME and IPG segments.

Excluding the divestiture of the GCM business, consolidated constant currency net sales declined 9.3% and 6.9% for the quarter and year-to-date, respectively, compared to the same periods last year, with net sales declines in lifestyle and respiratory products partially offset by increases in mobility and seating products.

The company realized a favorable impact from sales mix year-to-date attributable to mobility and seating products, which comprise most of the company's clinically complex product

portfolio. Sales mix increased to 38% from 33% for constant currency net sales by product for the second quarter of 2017 as compared to same period last year.

The table above provides net sales change as reported and as adjusted to exclude the impact of foreign exchange translation (constant currency net sales) as well as net sales further adjusted to exclude the impact of the sale of GCM, which was sold in September 2016 and not deemed a discontinued operation from an external reporting perspective.

“Constant currency net sales" is a non-GAAP financial measure, which is defined as net sales excluding the impact of foreign currency translation. The current year's functional currency net sales are translated using the prior year's foreign exchange rates. These amounts are then compared to the prior year's sales to calculate the constant currency net sales change. Management believes that this financial measure provides meaningful information for evaluating the core operating performance of the company.

MD&A Net Sales

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This favorable net sales mix shift is the result of the company's continued transformation and, in particular, the implementation of Phase One of the transformation, where the company focused on shifting and narrowing the product portfolio and alignment of resources to focus on clinically complex solutions.

Constant currency net sales performance drivers by segment:

Europe - The improvement in constant currency net sales for the quarter and year-to-date was driven by mobility and seating products partially offset by declines in lifestyle and respiratory products.

North America/Home Medical Equipment (NA/HME) - Excluding the divestiture of the GCM business, constant currency net sales declined 23.2% for the quarter compared to the same period last year. The decrease in constant currency net sales was driven by decreases in all categories, though mostly in lifestyle and respiratory products. Mobility and seating sales were a lesser part of the net sales decline. Newer mobility and seating products grew during the quarter, including the Alber® Twion® power assist device, Invacare® MyON® HC manual wheelchair and the Rovi® power wheelchair from Motion Concepts.

Institutional Products Group (IPG) - The decrease in constant currency net sales for the quarter was driven by most product categories except beds and interior design projects. The

decrease in constant currency net sales year-to-date was driven by all product categories. As previously disclosed, the company is transforming its go-to-market strategy in the post-acute care (PAC) channel. With the support of IPG's Outcomes by Design™ service offering for customers that launched in the second quarter, the new post-acute commercial team continued to build its new customer base. The company expects this new sales approach within the capital selling environment to take time to yield growth.

Asia/Pacific - The decrease in constant currency net sales for the quarter was driven by the Australia distribution business partially offset by improvements in the New Zealand distribution business and at the company's subsidiary that produces microprocessor controllers. The year-to-date improvement in constant currency net sales was driven by the New Zealand distribution businesses and the company's subsidiary that produces microprocessor controllers partially offset by declines in the Australia distribution business.

MD&A Gross Profit