THORATEC CORP
Form 10-Q
November 10, 2005

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U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark one)

þ **Quarterly report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**
For the quarterly period ended October 1, 2005

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: 1-8145
THORATEC CORPORATION
(Exact name of registrant as specified in its charter)

California	**94-2340464**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
6035 Stoneridge Drive, Pleasanton, California	**94588**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (925) 847-8600

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 R No £

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

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

As of November 7, 2005, the registrant had 50,633,460 shares of common stock outstanding.

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PART I. FINANCIAL INFORMATION
ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

THORATEC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)
(in thousands)

	October 1, 2005	January 1, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 25,643	$ 16,017
Short-term available-for-sale investments	158,788	129,842
Restricted short-term investments	3,370	3,362
Receivables, net of allowances of $910 and $708, respectively	31,511	33,051
Inventories	42,410	39,141
Deferred tax asset	6,470	6,470
Prepaid expenses and other assets	4,905	3,873
Total current assets	273,097	231,756
Property, plant and equipment, net	26,919	27,584
Goodwill	94,097	94,097
Purchased intangible assets, net	144,737	153,141
Restricted long-term investments	3,232	4,845
Long-term deferred tax asset	6,450	6,381
Other assets	6,318	6,611
Total Assets	$ 554,850	$ 524,415
Liabilities and Shareholders Equity		
Current liabilities:		
Accounts payable	7,312	7,699
Accrued compensation	12,560	9,507
Accrued income tax	3,805	2,299
Other accrued expenses	6,478	6,001
Total current liabilities	30,155	25,506
Senior subordinated convertible notes	143,750	143,750
Long-term deferred tax liability and other liabilities	60,310	63,051
Total liabilities	234,215	232,307
Shareholders Equity:		
Common shares; 100,000 authorized; issued and outstanding 50,064 and 48,735, respectively	385,194	364,775
Deferred compensation	(920)	(1,586)
Accumulated deficit	(63,341)	(71,514)
Accumulated other comprehensive income (loss):		

Unrealized loss on investments	(249)	(325)
Cumulative translation adjustments	(49)	758
Total accumulated other comprehensive income (loss)	(298)	433
Total shareholders equity	320,635	292,108
Total Liabilities and Shareholders Equity	$ 554,850	$ 524,415

See notes to condensed consolidated financial statements.

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THORATEC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)
(in thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	October 1, 2005	October 2, 2004	October 1, 2005	October 2, 2004
Product sales	$ 48,841	$ 40,661	$ 146,917	$ 124,055
Cost of product sales	18,610	17,646	57,045	51,680
Gross profit	30,231	23,015	89,872	72,375
Operating expenses:				
Selling, general and administrative	14,987	13,168	44,610	39,954
Research and development	8,093	6,970	23,737	21,689
Amortization of purchased intangible assets	2,800	2,931	8,404	8,793
Litigation		310	177	443
Total operating expenses	25,880	23,379	76,928	70,879
Income (loss) from operations	4,351	(364)	12,944	1,496
Other income and (expense):				
Interest expense	(1,037)	(1,015)	(3,082)	(1,433)
Interest income and other	1,113	693	2,983	1,633
Income (loss) before income tax benefit (expense)	4,427	(686)	12,845	1,696
Income tax benefit (expense)	(1,325)	288	(4,187)	(594)
Net income (loss)	$ 3,102	$ (398)	$ 8,658	$ 1,102
Net income (loss) per share:				
Basic	$ 0.06	$ (0.01)	$ 0.18	$ 0.02
Diluted	$ 0.06	$ (0.01)	$ 0.17	$ 0.02
Shares used to compute net income per share:				
Basic	49,562	50,114	48,835	53,304
Diluted	51,419	50,114	50,168	54,422

See notes to condensed consolidated financial statements.

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THORATEC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	Nine Months Ended	
	October 1, 2005	October 2, 2004
Cash flows from operating activities:		
Net income	$ 8,658	$ 1,102
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	14,246	14,014
Investment discount (premium) amortization	411	(466)
Non-cash interest and other expenses	1,286	1,435
Tax benefit related to stock options	4,106	404
Amortization of deferred compensation	779	682
Loss on disposal of assets	252	57
Change in net deferred tax liability	(3,164)	(2,759)
Changes in assets and liabilities:		
Receivables	1,540	(1,965)
Inventories	(4,383)	(5,361)
Prepaid expenses and other assets	(1,148)	(745)
Accounts payable and other liabilities	4,159	(220)
Other	150	(230)
Net cash provided by operating activities	26,892	5,948
Cash flows from investing activities:		
Purchases of available-for-sale investments	(100,540)	(174,810)
Sales of available-for-sale investments	45,233	92,500
Maturities of available-for-sale investments	27,560	21,620
Purchases of property, plant and equipment, net	(4,428)	(4,576)
Net cash used in investing activities	(32,175)	(65,266)
Cash flows from financing activities:		
Net proceeds from issuance of convertible debentures		139,453
Proceeds from stock option exercises, net	17,404	2,201
Proceeds from stock issued under employee stock purchase plan	550	775
Repurchase of common stock	(2,238)	(90,008)
Net cash provided by financing activities	15,716	52,421
Effect of exchange rate changes on cash and cash equivalents	(807)	48
Net increase in cash and cash equivalents	9,626	(6,849)
Cash and cash equivalents at beginning of period	16,017	18,270
Cash and cash equivalents at end of period	$ 25,643	$ 11,421

Supplemental disclosure of cash flow information:

Cash paid for taxes	$	1,903	$	511
Cash paid for interest	$	1,728	$	
Supplemental disclosure of non-cash investing and financing activities:				
Transfers of equipment from inventory	$	1,114	$	392

See notes to condensed consolidated financial statements.

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THORATEC CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(unaudited)
(in thousands)

	Three Months Ended		Nine Months Ended	
	October 1, 2005	**October 2, 2004**	**October 1, 2005**	**October 2, 2004**
Net income (loss)	$ 3,102	$ (398)	$ 8,658	$ 1,102
Other net comprehensive income (loss):				
Unrealized gain (loss) on investments (net of taxes of $(20) and $9 for the three months ended and ($69) and ($113) for the nine months ended October 1, 2005 and October 2, 2004, respectively)	36	3	76	(188)
Foreign currency translation adjustments (net of taxes of $75 and $0 for the three months ended and $230 and $0 for the nine months ended October 1, 2005 and October 2, 2004, respectively)	(195)	(13)	(807)	48
Comprehensive income (loss)	$ 2,943	$ (408)	$ 7,927	$ 962

See notes to condensed consolidated financial statements.

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THORATEC CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
(in thousands, unless otherwise stated)

1. Basis of Presentation

The interim condensed consolidated financial statements of Thoratec Corporation, referred to herein as we, our, Thoratec, or the Company, have been prepared and presented in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission, referred to as the SEC, without audit, and reflect all adjustments necessary (consisting only of normal recurring adjustments) to present fairly our financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in our annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. The accompanying financial statements should be read in conjunction with our fiscal 2004 consolidated financial statements filed with the SEC in our Annual Report on Form 10-K. The operating results for any interim period are not necessarily indicative of the results that may be expected for any future period.

The preparation of our condensed consolidated financial statements necessarily requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the condensed consolidated balance sheet dates and the reported amounts of revenues and expenses for the periods presented.

We have made certain reclassifications of 2004 amounts to conform to the current presentation. In balance sheets prior to January 1, 2005, auction rate securities were classified as cash and cash equivalents. These securities have been reclassified for all periods presented from cash and cash equivalents to short term available-for-sale investments. These auction rate securities have an underlying component of a long-term debt or equity instrument; however, they are traded or mature on a shorter term based on an auction bid that resets the interest rate over time intervals of 28 to 49 days. These resets allow for a much higher level of liquidity than typical long term investments. As of January 3, 2004, we reclassified $43.8 million of these securities to short-term available-for-sale investments from cash and cash equivalents based on the period from the purchase date to the reset date and, as they are not intended to be held to the maturity date but are intended to be held through the reset interval, they are considered less liquid then our typical cash and cash equivalents.

2. Stock Based Compensation

We account for stock-based compensation to employees using the intrinsic value method in accordance with Accounting Principals Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees. Accordingly, no accounting recognition is given to stock options granted at fair market value until they are exercised. Upon exercise, net proceeds, including tax benefits realized, are recorded in shareholders equity. Similarly, no accounting recognition is given to our employee stock purchase plan until a purchase occurs. Upon purchase, net proceeds are recorded in common stock. Under the fair value recognition provisions of Statement of Financial Accounting Standard (SFAS) No. 123, the fair value of each option granted as a stock option or as an option to purchase shares under the employee stock purchase plan is estimated using the Black-Scholes option-pricing model. If compensation cost for our stock-based plans had been determined based on the fair value at the grant dates for awards under those plans, consistent with the method of SFAS No. 123, our reported net income would have been adversely affected, as shown in the following table:

	Three Months Ended		Nine Months Ended	
	October 1, 2005	October 2, 2004	October 1, 2005	October 2, 2004
	(in thousands, except per share data)			
		(Restated)		(Restated)
Net income:				
As reported	$ 3,102	$ (398)	$ 8,658	$ 1,102
Add: Stock-based compensation expense included in reported net income, net of related tax effects	277	132	595	419
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(1,495)	(2,876)	(4,994)	(8,753)
Pro forma net income (loss)	$ 1,884	$ (3,142)	$ 4,259	$ (7,232)
Basic and Diluted earnings (loss) per share:				
As reported				
Basic	$ 0.06	$ (0.01)	$ 0.18	$ 0.02
Diluted	$ 0.06	$ (0.01)	$ 0.17	$ 0.02
Pro forma income (loss)				
Basic	$ 0.04	$ (0.06)	$ 0.09	$ (0.14)
Diluted	$ 0.04	$ (0.06)	$ 0.08	$ (0.14)

Subsequent to the issuance of our condensed consolidated financial statements for the quarter ended October 2, 2004, management determined that total stock based employee compensation expense calculated using the fair value based method, net of related tax effects, for the first three quarters of 2004 had been calculated incorrectly. Accordingly, such pro forma amounts presented above have been restated. The effect was to decrease pro forma stock-based compensation expense, net of tax and pro forma net loss by $0.1 million for the three months ended and $0.2 million for the nine months ended October 2, 2004. Pro forma earnings per share were also increased by $0.01 per share for basic and diluted earnings per share for the three and nine months ended October 2, 2004. This correction did not impact the Company s consolidated financial position, results of operations, or cash flows for any of the periods presented.

3. New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued statement 123R Share-Based Payment. This statement requires that stock-based compensation be recognized as a cost in the financial statements and that such cost be measured based on the fair value of the stock-based compensation. Our adoption of this statement, which we expect to occur in the first quarter of 2006, will have a material, although non-cash, impact on our consolidated statements of operations.

4. Cash and cash equivalents

We consider highly liquid investments with original maturities of three months or less to be cash and cash equivalents.

5. Investments

Investments classified as short-term available for sale are reported at fair value based upon quoted market prices and consist primarily of auction rate securities, corporate and municipal bonds, and U.S. government obligations. All investments mature within two years or less from the date of purchase, except for certain restricted investments in U.S. Treasuries held as collateral for future interest payments related to our convertible debt, which investments all mature within three years from the date of purchase. Investments with maturities beyond one year may be classified as short-term, if they are available and intended for use in current operations, based on their highly liquid nature or due to the frequency in which the interest rate is reset such as with auction rate securities. Investments that are not intended for use in current operations are classified as long-term investments.

Investments classified as restricted are securities held in U.S. Treasuries as collateral for future interest payments related to our convertible debt and are reported at fair value based upon quoted market price. The investments that relate to interest payments due within one year have been classified as restricted short-term investments and the investments that relate to interest payments due after one year have been classified as restricted long-term investments. We have determined that these investments had no impairments that were other-than temporary.

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For all investments, temporary differences between cost and fair value are presented as a separate component of accumulated other comprehensive income. The specific identification method is used to determine realized gains and losses on investments.

6. Financial Instruments

We have a foreign currency exchange risk management program principally designed to mitigate the change in value of assets and liabilities due to currency fluctuations (primarily assets and liabilities on our United Kingdom subsidiary s consolidated balance sheet that are denominated in Pounds Sterling). Forward exchange contracts that generally have terms of three months or less are used to hedge these currency exposures on our books. The derivatives used in the foreign currency exchange risk management program are not designated as cash flow or fair value hedges under SFAS 133. These contracts are recorded on the condensed consolidated balance sheets at fair value in Prepaid expenses and other assets . Changes in the fair value of the contracts and the underlying exposures being hedged are included concurrently in Interest income and other. At October 1, 2005 the Company had forward foreign currency contracts to exchange Euros for Pounds Sterling and Pounds Sterling for Dollars with a notional value of $7.4 million. At January 1, 2005, the Company had forward foreign currency contracts to exchange Pounds Sterling and Euros for U.S. Dollars with a notional value of $6.9 million. For both periods the fair values of these contracts were negligible. Net foreign currency exchange was negligible and a loss of $0.1 million for the three months ended, and was a gain of $0.3 million and negligible for the nine months ended, October 1, 2005, and October 2, 2004, respectively.

7. Inventories

Inventories consist of the following:

	As of October 1, 2005	As of January 1, 2005
	(in thousands)	
Finished goods	$ 19,958	$ 18,562
Work in process	8,002	4,582
Raw materials	14,450	15,997
Total	$ 42,410	$ 39,141

8. Property, Plant and Equipment

Property, plant and equipment, net, consist of the following:

	As of October 1, 2005	As of January 1, 2005
	(in thousands)	
Property, plant and equipment, at cost	$ 64,823	$ 61,670
Less accumulated depreciation	(37,904)	(34,086)
Total	$ 26,919	$ 27,584

In the third quarter of 2005 we adjusted the estimated lives of certain sales and marketing equipment from three years to two years. This change is not material to our condensed consolidated financial statements.

In September 2005, we agreed to purchase a 67,000-square foot office building in Pleasanton, California for approximately $13.4 million, subject to certain adjustments at closing. During the third quarter of 2005, we paid a deposit of $0.1 million which was recorded in Other assets on the balance sheet, with an additional $0.9 million due and payable at the end of the 30-day contingency period, in October 2005. The remaining amount due, $12.4 million, will be paid at the close of escrow which we expect to occur in January 2006.

9. Goodwill and Purchased Intangible Assets

The change in the carrying amount of goodwill, which is attributable to our Cardiovascular business segment, for the nine and twelve month periods ended October 1, 2005 and January 1, 2005 was as follows:

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	As of October 1, 2005	As of January 1, 2005
	(in thousands)	
Beginning balance	$ 94,097	$ 96,065
Realization of acquired deferred tax asset		(1,153)
Reversal of accrual for securities registration costs		(815)
Ending balance	$ 94,097	$ 94,097

There were no adjustments to goodwill in the first nine months of 2005. In 2004, goodwill related to the merger of Thoratec with Thermo Cardiosystems, Inc. (TCA) was adjusted by $1.2 million to reflect the utilization of tax net operating loss (NOL) benefits related to our subsidiary in the United Kingdom (UK). At the time of the merger, a deferred tax asset related to these NOL tax benefits was established with a corresponding valuation allowance for the full amount. As our UK subsidiary more likely than not will begin utilizing a portion of this NOL benefit, a portion of the original valuation allowance has been reversed against goodwill.

In addition, goodwill was also adjusted by $0.8 million in 2004 to reflect the reversal of an accrual established at the time of the merger with TCA for securities registration costs. Under the terms of the agreement, we agreed to pay these costs should Thermo Electron Corporation (TCI) (the majority shareholder of TCA prior to the merger) decide to sell its shares of the Company s common stock in a public offering. This commitment was enforceable until TCI s holdings in Thoratec fell below 10%, which occurred in the first quarter of 2004.

The components of purchased intangible assets, net, are as follows:

	As of October 1, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(in thousands)	
Patents and Trademarks	$ 37,815	$ (16,782)	$ 21,033
Core Technology	37,485	(8,382)	29,103
Developed Technology	122,782	(28,243)	94,539
Non-compete Agreement	90	(28)	62
Total Purchased Intangible Assets, net	$ 198,172	$ (53,435)	$ 144,737

	As of January 1, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
		(in thousands)	
Patents and Trademarks	$ 37,815	$ (14,051)	$ 23,764
Core Technology	37,485	(7,242)	30,243
Developed Technology	122,782	(23,721)	99,061

Non-compete Agreement	90		(17)		73
Total Purchased Intangible Assets, net	$ 198,172	$	(45,031)	$	153,141

Effective January 1, 2005, the Company revised its estimate for the remaining useful lives for certain of its core and developed technology intangible assets. The effect of the change was to decrease amortization expense by $0.4 million during the nine months ended October 1, 2005 and is expected to decrease amortization by $0.5 million during each of the next five years. Amortization expense related to purchased intangible assets, net, was $2.8 million and $8.4 million for the three and nine months ended October 1, 2005, respectively. Amortization expenses were $2.9 million and $8.8 million for the three and nine months ended October 2, 2004, respectively. Amortization expense on our existing purchased intangible assets is expected to be approximately $11.2 million for each of the next five years. Patents and trademarks have useful lives of eight to twenty years, core and developed technology assets have useful lives ranging from nine to twenty four years and the useful life of the non-compete agreement is approximately six years.

10. Long-Term Debt

In the second quarter of 2004, we completed the sale of $143.8 million initial principal amount of senior subordinated convertible notes due 2034. The convertible notes were sold to Qualified Institutional Buyers pursuant to the exemption from the registration requirements of the Securities Act of 1933, as amended, provided by Rule 144A thereunder. We used $9.8 million of the net proceeds to purchase and pledge to the trustee under the indenture for the exclusive benefit of the holders of the convertible notes, U.S. Treasury securities to provide for the payment, in full, of the first six scheduled interest payments. These securities are reflected on our condensed consolidated balance sheets as restricted short-term and long-term investments. Additional net proceeds were used to repurchase 4.2 million shares of our outstanding common stock for $60 million. The remaining net proceeds have been and will be used for general corporate purposes, which may include additional stock repurchases, strategic investments or acquisitions. Total net proceeds to the Company from the sale of these convertible notes were $139.4 million, after debt issuance costs of $4.3 million.

The convertible notes were issued at an issue price of $580.98 per note, which is 58.098% of the principal amount at maturity of the notes. The convertible notes bear interest at a rate of 1.3798% per year on the principal amount at maturity, payable semi-annually in arrears in cash on May 16 and November 16 of each year, from November 16, 2004 until May 16, 2011. Beginning on May 16, 2011, the original issue discount will accrue daily at a rate of 2.375% per year on a semi-annual bond equivalent basis and, on the maturity date, a holder will receive $1,000 per note. As a result, the aggregate principal amount of the notes at maturity will be $247.4 million.