DAVITA INC
Form 10-Q
November 03, 2006
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

For the Quarter Ended

September 30, 2006

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 1-14106

DAVITA INC.

601 Hawaii Street

El Segundo, California 90245

Telephone number (310) 536-2400

Delaware	**51-0354549**
(State of incorporation)	**(I.R.S. Employer Identification No.)**

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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 October 31, 2006, the number of shares of the Registrant s common stock outstanding was approximately 104.0 million shares and the aggregate market value of the common stock outstanding held by non-affiliates based upon the closing price of these shares on the New York Stock Exchange was approximately $5.8 billion.

Table of Contents

DAVITA INC.

INDEX

Note: Items 3, 4 and 5 of Part II are omitted because they are not applicable.

Table of Contents

DAVITA INC.

CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(dollars in thousands, except per share data)

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Net operating revenues	$ 1,237,041	$ 644,892	$ 3,608,045	$ 1,840,603
Operating expenses and charges:				
Patient care costs	857,049	435,212	2,517,795	1,235,952
General and administrative	113,447	60,820	329,059	174,939
Depreciation and amortization	44,478	25,410	128,086	74,188
Provision for uncollectible accounts	31,985	11,462	93,295	32,751
Minority interests and equity income, net	10,956	6,690	26,857	16,184
Valuation gain on Product Supply Agreement	(37,968)		(37,968)	
Total operating expenses and charges	1,019,947	539,594	3,057,124	1,534,014
Operating income	217,094	105,298	550,921	306,589
Debt expense	(67,904)	(24,284)	(206,799)	(66,700)
Swap valuation (loss) gain		(1,718)		4,543
Refinancing charges				(6,872)
Other income	3,271	2,059	10,118	5,741
Income from continuing operations before income taxes	152,461	81,355	354,240	243,301
Income tax expense	59,370	30,441	139,040	92,290
Income from continuing operations	93,091	50,914	215,200	151,011
Discontinued operations				
Income from operations of discontinued operations, net of tax		4,303		13,483
Gain on disposal of discontinued operations, net of tax	1,765		362	
Net income	$ 94,856	$ 55,217	$ 215,562	$ 164,494
Earnings per share:				
Basic earnings per share from continuing operations	$ 0.90	$ 0.50	$ 2.08	$ 1.50
Basic earnings per share	$ 0.91	$ 0.55	$ 2.09	$ 1.64

Diluted earnings per share from continuing operations	$ 0.88	$ 0.49	$ 2.04	$ 1.45
Diluted earnings per share	$ 0.90	$ 0.53	$ 2.04	$ 1.58
Weighted average shares for earnings per share:				
Basic	103,784,510	101,307,461	103,295,407	100,399,902
Diluted	105,923,976	104,371,789	105,643,406	103,803,975

See notes to condensed consolidated financial statements.

1

Table of Contents

DAVITA INC.

CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands, except per share data)

	September 30, 2006	December 31, 2005
ASSETS		
Cash and cash equivalents	$ 260,278	$ 431,811
Accounts receivable, less allowance of $161,361 and $138,598	902,745	853,560
Inventories	99,336	69,130
Other receivables	129,795	116,620
Other current assets	22,232	38,463
Deferred income taxes	198,372	144,824
Total current assets	1,612,758	1,654,408
Property and equipment, net	813,055	750,078
Amortizable intangibles, net	214,494	235,944
Investments in third-party dialysis businesses	2,179	3,181
Other long-term assets	44,289	41,768
Goodwill	3,657,355	3,594,383
	$ 6,344,130	$ 6,279,762
LIABILITIES AND SHAREHOLDERS EQUITY		
Accounts payable	$ 227,650	$ 212,049
Other liabilities	448,021	381,964
Accrued compensation and benefits	302,011	231,994
Current portion of long-term debt	6,640	71,767
Income taxes payable	26,035	91,959
Total current liabilities	1,010,357	989,733
Long-term debt	3,818,111	4,085,435
Other long-term liabilities	27,650	26,416
Alliance and product supply agreement and other, net	108,270	163,431
Deferred income taxes	121,208	75,499
Minority interests	111,722	88,639
Commitments and contingencies		
Shareholders equity:		
Preferred stock ($0.001 par value, 5,000,000 shares authorized; none issued)		
Common stock ($0.001 par value, 195,000,000 shares authorized; 134,862,283 shares issued)	135	135
Additional paid-in capital	615,939	569,751
Retained earnings	1,055,492	839,930
Treasury stock, at cost (30,909,676 and 32,927,026 shares)	(538,845)	(574,013)
Accumulated other comprehensive income	14,091	14,806

Total shareholders equity	1,146,812	850,609
	$ 6,344,130	$ 6,279,762

See notes to condensed consolidated financial statements.

2

Table of Contents

DAVITA INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(dollars in thousands)

	Nine months ended September 30,	
	2006	**2005**
Cash flows from operating activities:		
Net income	$ 215,562	$ 164,494
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	128,086	77,080
Valuation gain on Product Supply Agreement	(37,968)	
Stock-based compensation expense	18,896	2,601
Tax benefits from stock option exercises	29,261	34,420
Excess tax benefits from stock-based compensation	(27,146)	
Deferred income taxes	1,249	(8,950)
Minority interests in income of consolidated subsidiaries	28,812	18,225
Distributions to minority interests	(25,552)	(12,261)
Equity investment income	(1,955)	(822)
Loss (gain) on disposal of discontinued operation and other dispositions	508	(2,213)
Non-cash debt and other expenses	13,562	2,397
Refinancing charges		6,872
Swap valuation gain		(4,543)
Changes in operating assets and liabilities, other than from acquisitions and divestitures:		
Accounts receivable	(46,135)	(31,284)
Inventories	(29,118)	(2,670)
Other receivables and other current assets	(18,155)	(12,699)
Other long-term assets	(5,329)	(2,134)
Accounts payable	16,557	2,753
Accrued compensation and benefits	67,889	27,366
Other current liabilities	63,643	27,279
Income taxes	(65,924)	19,670
Other long-term liabilities	2,720	(3,371)
Net cash provided by operating activities	329,463	302,210
Cash flows from investing activities:		
Additions of property and equipment, net	(181,425)	(97,529)
Acquisitions and purchases of other ownership interests	(75,580)	(132,440)
Proceeds from divestitures and asset sales	21,348	2,327
Investments in and advances to affiliates, net	14,605	14,294
Intangible assets	(5,749)	(779)
Net cash used in investing activities	(226,801)	(214,127)

Cash flows from financing activities:		
Borrowings	4,493,339	1,742,433
Payments on long-term debt	(4,826,163)	(1,753,351)
Deferred financing costs	296	(30,561)
Excess tax benefits from stock-based compensation	27,146	
Stock option exercises and other share issuances, net	31,187	38,613
Net cash used in financing activities	(274,195)	(2,866)
Net (decrease) increase in cash and cash equivalents	(171,533)	85,217
Cash and cash equivalents at beginning of period	431,811	251,979
Cash and cash equivalents at end of period	$ 260,278	$ 337,196

See notes to condensed consolidated financial statements.

3

Table of Contents

DAVITA INC.

CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY

AND

COMPREHENSIVE INCOME

(unaudited)

(dollars and shares in thousands)

	Common stock		Additional paid-in capital	Retained earnings	Treasury stock		Accumulated comprehensive income	Total
	Shares	Amount			Shares	Amount		
Balance at December 31, 2004	134,862	$ 135	$ 542,714	$ 611,287	(36,295)	$ (632,732)	$ 1,730	$ 523,134
Comprehensive income:								
Net income				228,643				228,643
Unrealized gain on interest rate swaps, net of tax							16,821	16,821
Less reclassification of net swap valuation gains into net income, net of tax							(3,745)	(3,745)
Total comprehensive income								241,719
Stock purchase shares issued			657		64	1,118		1,775
Stock unit shares issued			(492)		28	492		
Stock options exercised			(14,965)		3,276	57,109		42,144
Stock-based compensation expense			3,353					3,353
Tax benefits from stock awards exercised			38,484					38,484
Balance at December 31, 2005	134,862	135	569,751	839,930	(32,927)	(574,013)	14,806	850,609
Comprehensive income:								
Net income				215,562				215,562
Net unrealized loss on interest rate swaps, net of tax							(715)	(715)
Total comprehensive income								214,847
Stock purchase shares issued			1,861		80	1,402		3,263
Stock unit shares issued			(1,040)		113	1,970		930
Stock options exercised			(2,790)		1,824	31,796		29,006
Stock-based compensation expense			18,896					18,896
Tax benefits from stock awards exercised			29,261					29,261
Balance at September 30, 2006	134,862	$ 135	$ 615,939	$ 1,055,492	(30,910)	$ (538,845)	$ 14,091	$ 1,146,812

See notes to condensed consolidated financial statements.

4

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(dollars in thousands, except per share data)

Unless otherwise indicated in this Quarterly Report on Form 10-Q the Company , we , us , our and similar terms refer to DaVita Inc. and its consolidated subsidiaries.

1. Condensed consolidated interim financial statements

The condensed consolidated interim financial statements included in this report are prepared by the Company without audit. In the opinion of management, all adjustments consisting only of normal recurring items necessary for a fair presentation of the results of operations are reflected in these consolidated interim financial statements. All significant intercompany accounts and transactions have been eliminated. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. The most significant estimates and assumptions underlying these financial statements and accompanying notes generally involve revenue recognition and provisions for uncollectible accounts, impairments and valuation adjustments, accounting for income taxes, variable compensation accruals, purchase accounting valuation estimates and stock-based compensation. The results of operations for the three and nine months ended September 30, 2006 are not necessarily indicative of the operating results for the full year. The consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005. The operating results for prior periods have been adjusted to retroactively reflect the operating results of the historical DaVita divested centers and a terminated management services agreement as discontinued operations. Prior year balances and amounts have been classified to conform to the current year presentation.

2. Earnings per share

Basic net income per share is calculated by dividing net income by the weighted average number of common shares and vested stock units outstanding. Diluted net income per share includes the dilutive effect of outstanding stock options, stock appreciation rights and unvested stock units (under the treasury stock method).

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

The reconciliations of the numerators and denominators used to calculate basic and diluted net income per share are as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
	(shares in thousands)			
Basic:				
Income from continuing operations	$ 93,091	$ 50,914	$ 215,200	$ 151,011
Income from discontinued operations, net of tax		4,303		13,483
Gain on disposal of discontinued operations, net of tax	1,765		362	
Net income	$ 94,856	$ 55,217	$ 215,562	$ 164,494
Weighted average shares outstanding during the period	103,734	101,258	103,244	100,351
Vested stock units	51	49	51	49
Weighted average shares for basic earnings per share calculations	103,785	101,307	103,295	100,400
Basic earnings per share from continuing operations	$ 0.90	$ 0.50	$ 2.08	$ 1.50
Income from discontinued operations		0.05		0.14
Gain on disposal of discontinued operations	0.01		0.01	
Basic earnings per share	$ 0.91	$ 0.55	$ 2.09	$ 1.64
Diluted:				
Income from continuing operations	$ 93,091	$ 50,914	$ 215,200	$ 151,011
Income from discontinued operations, net of tax		4,303		13,483
Gain on disposal of discontinued operations, net of tax	1,765		362	
Net income for diluted earnings per share calculation	$ 94,856	$ 55,217	$ 215,562	$ 164,494
Weighted average shares outstanding during the period	103,734	101,258	103,244	100,351
Vested stock units	51	49	51	49
Assumed incremental shares from stock plans	2,139	3,065	2,348	3,404
Weighted average shares for diluted earnings per share calculation	105,924	104,372	105,643	103,804

Diluted earnings per share from continuing operations	$ 0.88	$ 0.49	$ 2.04	$ 1.45
Income from discontinued operations		0.04		0.13
Gain on disposal of discontinued operations	0.02			
Diluted earnings per share	$ 0.90	$ 0.53	$ 2.04	$ 1.58

Shares associated with stock options and stock appreciation rights that have exercise or base prices greater than the average market price of shares outstanding during the period were not included in the computation of diluted earnings per share because they were anti-dilutive. These excluded shares were as follows:

	Three months ended September 30,		**Nine months ended September 30,**	
	2006	**2005**	**2006**	**2005**
Stock award shares not included in computation (shares in 000 s)	365	62	352	1,658
Exercise price range of shares not included in computation:				
Low	$ 54.57	$ 46.18	$ 54.67	$ 43.86
High	$ 60.21	$ 47.75	$ 60.21	$ 47.75

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

3. Stock-based compensation

Effective January 1, 2006, the Company implemented Statement of Financial Accounting Standards No. 123(R) *Share-Based Payment*, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors, including stock options, stock units, stock appreciation rights and employee stock purchases. Under this standard, the Company s stock-based compensation awards are measured at estimated grant-date fair value and recognized as compensation expense over their requisite service periods. FAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees*, under which the Company did not recognize compensation expense for most stock options. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 relating to the application of FAS 123(R), and the Company has applied the provisions of SAB 107 in its adoption of FAS 123(R).

The Company implemented FAS 123(R) using the modified prospective transition method. In accordance with this method, our condensed consolidated financial statements for periods prior to the first quarter of 2006 have not been restated to reflect this change. The standard also requires that tax benefits realized from stock award exercise gains in excess of stock-based compensation expense recognized for financial statement purposes be reported as cash flows from financing activities rather than as operating cash flows. The Company also elected to use the method available under FASB Staff Position FSP No. 123(R)-3 *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*, which provides an alternative method for calculating historical excess tax benefits from the method described in FAS 123(R) for stock-based compensation awards.

Under FAS 123(R), stock-based compensation recognized during a period is based on the estimated grant-date fair value of the portion of the stock-based award vesting during that period, adjusted for expected forfeitures. Stock-based compensation recognized in the Company s condensed consolidated financial statements for the nine months ended September 30, 2006 includes compensation cost for stock-based awards granted prior to, but not fully vested as of, December 31, 2005 and stock-based awards granted in the first nine months of 2006. The Company previously recognized the effect of stock unit forfeitures as they occurred, and the effect of transitioning to recognition of expense based on expected forfeitures was insignificant. Shares issued upon exercise of stock awards are generally issued from shares in treasury.

Stock-based compensation plans and arrangements

The Company s stock-based compensation plans and arrangements are described below.

2002 Plan. The DaVita Inc. 2002 Equity Compensation Plan (the 2002 Plan) provides for grants of stock-based awards to employees, directors and other individuals providing services to the Company, except that incentive stock options may only be awarded to employees. The plan mandates a maximum award term of five years, and stipulates that stock options and stock appreciation rights be granted with prices not less than the fair market value on the date of grant. The plan further requires that full share awards such as restricted stock units reduce shares available under the plan at a rate of 2.75:1. The Company s nonqualified stock options and nonqualified stock units awarded under this plan generally vest over 48 to 60 months from the date of grant. On July 1, 2006, the Company granted 2,214,500 stock-settled stock appreciation rights to employees under this plan, which generally vest over 24 to 52 months from the date of grant. At September 30, 2006, there were 7,466,550 stock options and stock appreciation rights and 380,819 stock units outstanding and 8,185,475 shares available for future grants under this plan.

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

1999 Plan. The 1999 Non-Executive Officer and Non-Director Equity Compensation Plan provides for grants of stock options to employees and other individuals providing services, other than executive officers and members of the Board of Directors. The Company awards nonqualified stock options under this plan which are generally issued with exercise prices equal to the market price of the stock on the date of grant, vest over 48 to 52 months from the date of grant and bear maximum award terms of five years. At September 30, 2006, there were 1,405,352 stock options outstanding and 235,454 shares available for future grants under this plan.

Predecessor plans. Upon shareholder approval of the 2002 Plan on April 11, 2002, the following predecessor plans were terminated, except with respect to options then outstanding: the 1994 Equity Compensation Plan, the 1995 Equity Compensation Plan, the 1997 Equity Compensation Plan, and the 1999 Equity Compensation Plan. Shares available for future grants under these predecessor plans were transferred to the 2002 Plan upon its approval, and cancelled predecessor plan awards become available for new awards under the 2002 Plan. Stock options granted under these terminated plans were generally issued with exercise prices equal to the market price of the stock on the date of grant, vested over four years from the date of grant, and bore maximum award terms of five to 10 years. The RTC Plan, a special purpose option plan related to the merger between the Company and Renal Treatment Centers, Inc. in 1998, was terminated in 1999. At September 30, 2006, there were 982,951 stock options outstanding under these terminated plans.

Deferred stock unit agreements. During 2001 through 2003, the Company made nonqualified stock unit awards to members of the Board of Directors and certain key executive officers under stand-alone deferred stock unit agreements. These awards vest over one to four years and are settled in stock when they vest or at a later date at the election of the recipient. At September 30, 2006, there were 96,278 stock units outstanding under these agreements.

A combined summary of the status of awards under these stock-based compensation plans and agreements is as follows:

	Nine months ended September 30, 2006				
	Stock options and stock appreciation rights			Stock units	
	Awards	Weighted average exercise price	Weighted average remaining contractual life	Awards	Weighted average remaining contractual life
Outstanding at beginning of year	9,269,781	$ 26.73		474,956	
Granted	2,913,500	$ 50.71		162,948	
Exercised	(1,823,885)	$ 15.90		(112,239)	
Forfeited	(504,543)	$ 36.24		(48,568)	

Outstanding at end of period	9,854,853	$ 35.33	3.4	477,097	3.3
Awards exercisable at end of period	3,142,383	$ 17.84	2.2	50,779	2.0
Weighted-average fair value of awards granted during the period	$ 13.13			$ 51.46	

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

Range of exercise prices	Awards outstanding	Weighted average exercise price	Awards exercisable	Weighted average exercise price
$ 0.00 $ 0.00	477,097	$	50,779	$
$ 0.01 $10.00	812,569	4.35	812,569	4.35
$10.01 $20.00	1,755,332	14.26	1,289,950	14.39
$20.01 $30.00	721,894	27.89	273,270	27.60
$30.01 $40.00	1,200,933	30.97	544,010	30.67
$40.01 $50.00	4,266,475	47.81	222,584	43.79
$50.01 $60.00	1,080,650	53.02		
$60.01 $70.00	17,000	60.21		
Total	10,331,950	$ 33.70	3,193,162	$ 17.56

For the nine months ended September 30, 2006, the aggregate intrinsic value of stock awards exercised was $80,300. At September 30, 2006, the aggregate intrinsic value of stock awards outstanding was $249,800 and the aggregate intrinsic value exercisable was $128,700. For the nine months ended September 30, 2005, the aggregate intrinsic value of stock awards exercised was $93,300.

Estimated fair value of stock-based compensation awards

The Company has estimated the grant-date fair value of stock option and stock-settled stock appreciation rights awards using the Black-Scholes-Merton valuation model and stock unit awards at intrinsic value on the date of grant. The following assumptions were used in estimating these values and determining the total stock-based compensation attributable to the current period:

Expected term of the awards: The expected term of awards granted represents the period of time that they are expected to remain outstanding from the date of grant. The Company determines the expected term of its stock awards based on its historical experience with similar awards, considering the Company s historical exercise and post-vesting termination patterns, and the terms expected by peer companies in near industries.

Expected volatility: Expected volatility represents the volatility anticipated over the expected term of the award. The Company determines the expected volatility for its awards based on the volatility of the price of its common stock over the most recent retrospective period commensurate with the expected term of the award, considering the volatility expectations implied by the market price of its exchange-traded options and the volatilities expected by peer companies in near industries.

Expected dividend yield: The Company has not paid dividends on its common stock and has no current plans to pay dividends in the future.

Risk-free interest rate: The Company bases the expected risk-free interest rate on the implied yield currently available on stripped interest coupons of U.S. Treasury issues with a remaining term equivalent to the expected term of the award.

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

A summary of the weighted average valuation inputs described above used for estimating the grant-date fair value of stock options and stock appreciation rights granted in the periods indicated is as follows:

	Nine months ended September 30,	
	2006	**2005**
		pro-forma
Expected term	3.4 years	3.1 years
Expected volatility	25.0%	27.2%
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	5.0%	4.0%

The Company estimates expected forfeitures based upon historical experience with separate groups of employees that have exhibited similar forfeiture behavior. Stock-based compensation expense is recorded only for awards that are expected to vest.

For the nine months ended September 30, 2006, the Company recognized $18,896 in stock-based compensation expense for stock options, stock appreciation rights, stock units and employee stock purchases, which is primarily included in general and administrative expenses in continuing operations. The estimated tax benefit recorded for this stock-based compensation was $6,915. As of September 30, 2006, there was $67,800 of total estimated unrecognized compensation cost related to nonvested stock-based compensation arrangements under the Company s equity compensation and stock purchase plans. The Company expects to recognize this cost over a weighted average remaining period of 1.7 years.

During the nine months ended September 30, 2006, the Company received $29,006 in cash proceeds from stock option exercises and $29,261 in total actual tax benefits upon the exercise of stock awards.

Pro forma year to date comparison under FAS 123(R) and APB 25

The following table presents the impact of the adoption of FAS 123(R) on selected items from the Company s condensed consolidated financial statements for the nine months ended September 30, 2006:

	Nine months ended September 30, 2006	
	As reported under FAS 123(R)	If reported under APB 25
Condensed consolidated statement of income:		
Operating income	$ 550,921	$ 566,682
Income from continuing operations before taxes	$ 354,240	$ 370,001
Income from continuing operations	$ 215,200	$ 225,265
Net income	$ 215,562	$ 225,627
Basic earnings per share from continuing operations	$ 2.08	$ 2.18
Basic earnings per share	$ 2.09	$ 2.19
Diluted earnings per share from continuing operations	$ 2.04	$ 2.13
Diluted earnings per share	$ 2.04	$ 2.13
Condensed consolidated statement of cash flows:		
Net cash provided by operating activities	$ 329,463	$ 356,609
Net cash used in financing activities	$ (274,195)	$ (301,341)

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

Pro forma prior year-to-date results under FAS 123

The weighted average grant-date fair value of stock awards granted in the three and nine months ended September 30, 2005 was $12.35 and $12.34, respectively. If the Company had adopted the fair value-based compensation expense provisions of Statement of Financial Accounting Standards No. 123 upon the issuance of that standard, net earnings and net earnings per share for the nine months ended September 30, 2005 would have been adjusted to the pro forma amounts indicated below (shares in 000 s):

	Three months ended September 30, 2005	Nine months ended September 30, 2005
Net income:		
As reported	$ 55,217	$ 164,494
Add: Stock-based employee compensation expense included in reported net income, net of tax	458	1,612
Deduct: Total stock-based employee compensation expense under the fair value-based method, net of tax	(2,650)	(8,847)
Pro forma net income	$ 53,025	$ 157,259
Pro forma basic earnings per share:		
Pro forma net income for basic earnings per share calculation	$ 53,025	$ 157,259
Weighted average shares outstanding	101,258	100,351
Vested stock units	49	49
Weighted average shares for basic earnings per share calculation	101,307	100,400
Basic net income per share Pro forma	$ 0.52	$ 1.57
Basic net income per share As reported	$ 0.55	$ 1.64
Pro forma diluted earnings per share:		
Pro forma net income for diluted earnings per share calculation	$ 53,025	$ 157,259
Weighted average shares outstanding	101,258	100,351

Vested stock units	49	49
Assumed incremental shares from stock plans	2,940	3,241
Weighted average shares for diluted earnings per share calculation	104,247	103,641
Diluted net income per share Pro forma	$ 0.51	$ 1.52
Diluted net income per share As reported	$ 0.53	$ 1.58

Employee stock purchase plan. The Employee Stock Purchase Plan entitles qualifying employees to purchase up to $25 of the Company s common stock during each calendar year. The amounts used to purchase stock are accumulated through payroll withholdings or through optional lump sum payments made in advance of the first day of the purchase right period. This compensatory plan allows employees to purchase stock for the lesser of 100% of the fair market value on the first day of the purchase right period or 85% of the fair market value on the last day of the purchase right period. Purchase right periods begin on January 1 and July 1, and end on December 31. Payroll withholdings and lump-sum payments related to the plan, included in accrued compensation and benefits, were $4,868 and $3,263 at September 30, 2006 and December 31, 2005, respectively. During the nine months ended September 30, 2006, 80,442 shares were issued to satisfy obligations under the

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

plan for purchase right periods in 2005. The fair value of employees purchase rights was estimated as of the beginning dates of the purchase right periods using the Black-Scholes-Merton valuation model with the following weighted average assumptions for purchase right periods in 2006 and 2005, respectively: expected volatility of 23% and 27%, risk-free interest rate of 4.9% and 3.2%, and no dividends. Using these assumptions, the weighted average estimated fair value of these purchase rights was $12.36 and $10.64 for 2006 and 2005, respectively.

4. Long-term debt

Long-term debt was comprised of the following:

	September 30, 2006	December 31, 2005
Term loan A	$ 279,250	$ 341,250
Term loan B	2,180,875	2,443,875
Senior and senior subordinated notes	1,350,000	1,350,000
Capital lease obligations	6,637	7,320
Acquisition obligations and other notes payable	7,989	14,757
	3,824,751	4,157,202
Less current portion	(6,640)	(71,767)
	$ 3,818,111	$ 4,085,435

Scheduled maturities of long-term debt at September 30, 2006 were as follows:

2006	$ 1,727
2007	18,056
2008	55,190
2009	63,217
2010	88,030
2011	519,731
Thereafter	3,078,800

During the first nine months of 2006, the Company made principal payments of $62,000 on the term loan A and $263,000 on the term loan B, including principal prepayments of $53,000 and $257,000 respectively. On November 1, 2006, the Company made an additional principal prepayment of $75,000 on the term loan B. Because of the principal prepayments, the Company s next mandatory principal payments are $12,375 in 2007 for the term loan A and $378,625 in 2011 for the term loan B.

On March 1, 2006, the Company s interest rate margins on its term loan A and term loan B (collectively, the Credit Facility), were reduced by 0.25% as a result of achieving certain financial ratios as defined in the Credit Facility. The term loan A currently bears interest at LIBOR plus 1.75% and the term loan B currently bears interest at LIBOR plus 2.00%. The margins are subject to adjustment depending upon changes in certain financial ratios of the Company and can range from 1.50% to 2.25% for the revolving credit facility and term loan A, and 2.00% to 2.25% for the term loan B.

The Company s senior and senior subordinated notes consist of $500,000 of 6 5/8% senior notes due 2013 and $850,000 of 7 1/4% senior subordinated notes due 2015. The notes are guaranteed by substantially all of the Company s direct and indirect wholly-owned subsidiaries and require semi-annual interest payments. The

12

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

Company may redeem some or all of the senior notes at any time on or after March 15, 2009 and some or all of the senior subordinated notes at any time on or after March 15, 2010.

As of September 30, 2006, the Company maintained a total of nine interest rate swap agreements, with notional amounts totaling $1,472,000. These agreements had the economic effect of modifying the LIBOR-based variable interest rate on the Company s debt to fixed rates ranging from 3.08% to 4.27%, resulting in a weighted average effective interest rate of 5.88% on the hedged portion of the Credit Facility, including the term loan B margin of 2.00%. The swap agreements require quarterly interest payments, bear amortizing notional amounts, and expire in 2008 through 2010. During the first nine months of 2006, the Company accrued net cash benefits of $11,249 from these swaps which is included in debt expense. As of September 30, 2006, the total fair value of these swaps was an asset of $32,816 and is principally included in other long-term assets.

Total comprehensive income for the three and nine months ended September 30, 2006 was $84,513 and $214,847, respectively, including other comprehensive income valuation losses on swaps of $10,343 and $715, respectively, net of tax.

Total comprehensive income for the three and nine months ended September 30, 2005 was $67,549 and $173,765, respectively, including other comprehensive income valuation gains on swaps of $12,332 and $9,271, respectively, net of tax.

As of September 30, 2006, the interest rates were economically fixed on approximately 60% of the Company s variable rate debt and approximately 74% of its total debt.

As a result of the swap agreements, the overall effective weighted average interest rate on the Credit Facility was 6.55%, based upon the current margins in effect ranging from 1.75% to 2.00%, as of September 30, 2006.

The Company s overall average effective interest rate excluding amortization of deferred financing costs during the third quarter of 2006 was 6.75% and as of September 30, 2006 was 6.72%.

The Company has undrawn revolving credit facilities totaling $253,000 of which approximately $49,000 was committed for outstanding letters of credit.

5. Contingencies

The majority of the Company s revenues are from government programs and may be subject to adjustment as a result of: (1) examination by government agencies or contractors, for which the resolution of any matters raised may take extended periods of time to finalize; (2) differing interpretations of government regulations by different fiscal intermediaries or regulatory authorities; (3) differing opinions regarding a patient s medical diagnosis or the medical necessity of services provided; and (4) retroactive applications or interpretations of governmental requirements. In addition, the Company s revenues from commercial payors may be subject to adjustment as a result of potential claims for refunds from commercial payors, as a result of government actions or as a result of other claims by commercial payors.

United States Attorney inquiries

On March 4, 2005, the Company received a subpoena from the United States Attorney s Office, or U.S. Attorney s Office, for the Eastern District of Missouri in St. Louis. The subpoena requires production of a wide range of documents relating to the Company s operations, including documents related to, among other things, pharmaceutical and other services provided to patients, relationships with pharmaceutical companies, and

13

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

financial relationships with physicians and joint ventures. The subpoena covers the period from December 1, 1996 through the present. The subpoena significantly overlaps with the subject matter of the investigation being conducted by the United States Attorney s Office for the Eastern District of Pennsylvania discussed below. In October 2005, the Company received a follow-up request for additional documents related to specific medical director and joint venture arrangements. In February 2006, the Company received an additional subpoena for documents, including certain patient records relating to the administration and billing of Epogen (EPO). The Company is producing documents and providing information to the government. The Company is also cooperating, and intends to continue to cooperate, with the government s investigation, including by participating in discussions and meetings with the government. The subpoenas have been issued in connection with a joint civil and criminal investigation. It is possible that criminal proceedings may be initiated against the Company in connection with this inquiry. Any negative findings could result in substantial financial penalties against the Company, exclusion from future participation in the Medicare and Medicaid programs and criminal penalties. To the Company s knowledge, no proceedings have been initiated against it at this time. Although the Company cannot predict whether or when proceedings might be initiated or when these matters may be resolved, it is not unusual for investigations such as this to continue for a considerable period of time. Responding to the subpoenas will continue to require management s attention and significant legal expense.

On October 25, 2004, the Company received a subpoena from the U.S. Attorney s Office for the Eastern District of New York in Brooklyn. The subpoena covers the period from 1996 to present and requires the production of a wide range of documents relating to the Company s operations, including DaVita Laboratory Services. The subpoena also includes specific requests for documents relating to testing for parathyroid hormone levels (PTH), and to products relating to vitamin D therapies. The subpoena has been issued in connection with a joint civil and criminal investigation. It is possible that criminal proceedings may be initiated against the Company in connection with this inquiry. Any negative findings could result in substantial financial penalties against the Company and DVA Renal Healthcare, exclusion from future participation in the Medicare and Medicaid programs and criminal penalties. Other participants in the dialysis industry received a similar subpoena, including Fresenius Medical Group, Renal Care Group and DVA Renal Healthcare, which was acquired by the Company in October of 2005. To the Company s knowledge, no proceedings have been initiated against the Company or DVA Renal Healthcare at this time. Although the Company cannot predict whether or when proceedings might be initiated or when these matters may be resolved, it is not unusual for investigations such as these to continue for a considerable period of time. Responding to the subpoena will continue to require management s attention and significant legal expense.

In February 2001, the Civil Division of the U.S. Attorney s Office for the Eastern District of Pennsylvania in Philadelphia contacted the Company and requested its cooperation in a review of some of its historical practices, including billing and other operating procedures and the Company s financial relationships with physicians. The Company cooperated in this review and provided the requested records to the U.S. Attorney s Office. In May 2002, the Company received a subpoena from the U.S. Attorney s Office and the Philadelphia Office of the Office of Inspector General of the Department of Health and Human Services (OIG). The subpoena requires an update to the information the Company provided in its response to the February 2001 request, and also seeks a wide range of documents relating to pharmaceutical and other ancillary services provided to patients, including laboratory and other diagnostic testing services, as well as documents relating to the Company s financial relationships with physicians and pharmaceutical companies. The subpoena covers the period from May 1996 to May 2002. The Company has provided the documents requested and continues to cooperate with the United States Attorney s Office and the OIG in its investigation. If this review proceeds, the government could expand its areas of concern. To the Company s knowledge, no proceedings have been initiated against it at this time. Although the Company cannot predict whether or when proceedings might be initiated or when these

14

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

matters may be resolved, it is not unusual for investigations such as this to continue for a considerable period of time. Any negative findings could result in substantial financial penalties against the Company and exclusion from future participation in the Medicare and Medicaid programs.

Other

The Company has received several notices of claims from commercial payors and other third parties related to the historical billing practices of the Company and claims against DVA Renal Healthcare related to historical DVA Renal Healthcare billing practices and other matters covered by their settlement agreement with the Department of Justice. While no litigation has been filed with respect to these claims to date, litigation against the Company has been threatened. The Company intends to defend against these claims vigorously; however, the Company may not be successful and these claims may lead to litigation and any such litigation may be resolved unfavorably. Although the ultimate outcome of these claims cannot be predicted at this time, an adverse result in excess of the Company s established reserves, with respect to one or more of these claims could have a material adverse effect on the Company s business, financial condition and results of operations.

The Company has received several informal inquiries from representatives of the New York Attorney General s Medicaid Fraud Control Unit (MFCU) regarding certain aspects of the EPO and other billing practices taking place at facilities managed by the Company in New York. The Company is cooperating with the MFCU s informal inquiries and has provided documents and information to the MFCU. To the best of the Company s knowledge, no proceedings have been initiated against the Company and the MFCU has not indicated an intention to do so, although the Company cannot predict whether it will receive further inquiries or whether or when proceedings might be initiated.

In June 2004, DVA Renal Healthcare was served with a complaint filed in the Superior Court of California by one of its former employees who worked for its California acute services program. The complaint, which is styled as a class action, alleges, among other things, that DVA Renal Healthcare failed to provide overtime wages, defined rest periods and meal periods, or compensation in lieu of such provisions and failed to comply with certain other California labor code requirements. The Company is evaluating the claims and intends to vigorously defend itself in the matter. It also intends to vigorously oppose the certification of this matter as a class action. Although the ultimate outcome of these claims cannot be predicted, the Company does not expect that an unfavorable result, if any, would have a material adverse effect on the Company s business, financial condition, liquidity or results of operations.

On August 8, 2005, Blue Cross/Blue Shield of Louisiana filed a complaint in the United States District Court for the Western District of Louisiana against Gambro AB, DVA Renal Healthcare and related entities. The plaintiff sought to bring its claims as a class action on behalf of itself and all entities that paid any of the defendants for health care goods and services from on or about January 1991 through at least December 2004. The complaint alleged, among other things, damages resulting from facts and circumstances underlying DVA Renal Healthcare s December 2004 settlement agreement with the Department of Justice and certain agencies of the United States Government. In March 2006, the case was dismissed and the plaintiff was compelled to seek arbitration to resolve the matter. In August 2006, the plaintiff proceeded with a demand to compel arbitration. At this time, the Company cannot estimate the potential range of damages, if any. The Company is investigating these claims and continues to vigorously defend itself in the matter.

In addition to the foregoing, the Company is subject to claims and suits in the ordinary course of business, including from time to time, contractual disputes and professional and general liability claims. The Company

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

believes that the ultimate resolution of any such pending proceedings, whether the underlying claims are covered by insurance or not, will not have a material adverse effect on the Company s financial condition, results of operations or cash flows.

6. Other commitments

The Company has obligations to purchase the third-party interests in several of its joint ventures. These obligations are in the form of put provisions in joint venture agreements, and are exercisable at the third-party owners discretion. If these put provisions are exercised, the Company would be required to purchase the third-party owners interests at either the appraised fair market value or a predetermined multiple of cash flow or earnings, which approximates fair value. As of September 30, 2006, the Company s potential obligations under these put provisions totaled approximately $187,000 of which approximately $108,000 was exercisable within one year. Additionally, the Company has certain other potential commitments to provide operating capital to several minority-owned centers and to third-party centers that the Company operates under administrative service agreements of approximately $15,000.

The Company is obligated under mandatorily redeemable instruments in connection with certain consolidated joint ventures. Future distributions may be required for the minority partners interests in limited-life entities which dissolve after terms of ten to fifty years. As of September 30, 2006, such distributions would be valued below the related minority interests balances in the consolidated balance sheet.

7. Acquisitions

During the first nine months of 2006, the Company acquired dialysis businesses consisting of 19 centers, for a total of $73,929 in cash and deferred purchase price obligations. The assets and liabilities for all acquisitions were recorded at their estimated fair market values at the dates of the acquisitions and are included in the Company s financial statements and operating results from the designated effective date of the acquisitions. The operating results of these acquisitions for the nine months ended September 30, 2006 were not material.

The purchase cost allocations for acquired businesses are recorded at fair values based upon the best information available to management and are finalized when identified pre-acquisition contingencies have been resolved and other information arranged to be obtained has been received.

The total purchase cost allocations were as follows:

		Nine months ended September 30, 2006
Tangible assets	$	5,164
Amortizable intangible assets		6,455
Goodwill		62,310
Total purchase costs	$	73,929

The amortizable intangible assets acquired are amortized using the straight-line method over a weighted-average amortization period of ten years. The goodwill associated with these acquisitions is expected to be deductible for tax purposes over a period of 15 years.

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

In October 2005, the Company completed its acquisition of DVA Renal Healthcare (formerly known as Gambro Healthcare, Inc.). The initial allocations of purchase cost were recorded at fair value based upon the best information available to management at the time. The fair values of certain property and equipment and intangible assets and liabilities have been valued by an independent third party. During the third quarter of 2006, the Company completed the final valuations of certain assets, properties and leasehold improvements, settlement liabilities and contingencies that were previously unresolved. The valuation adjustments were not material to the consolidated financial statements and were recorded with a corresponding adjustment to goodwill.

Pro forma information

The following summary, prepared on a pro forma basis, combines the results of operations for the acquisition of DVA Renal Healthcare and the related divestitures (See Note 9) for the first nine months of 2005, as if these transactions were consummated as of the beginning of 2005.

	Nine months ended September 30, 2005
Pro forma net revenues	$ 3,241,790
Pro forma income from continuing operations	166,198
Pro forma basic income per share from continuing operations	1.66
Pro forma diluted income per share from continuing operations	1.60

8. Alliance and Product Supply Agreement

On May 29, 2006, the Company notified Gambro Renal Products Inc. (Gambro Renal Products) that the Company was terminating the Alliance and Product Supply Agreement (the Product Supply Agreement) with Gambro AB and Gambro Renal Products. The Product Supply Agreement was entered into on October 5, 2005, in conjunction with the Company s acquisition of DVA Renal Healthcare and committed the Company to purchase a significant majority of its hemodialysis products supplies and equipment at fixed prices. The Company s termination notice claimed a material breach by Gambro Renal Products for failure to perform its obligations under the Product Supply Agreement primarily as a result of an import ban issued by the U.S. Food and Drug Administration affecting certain hemodialysis products.

On August 25, 2006, the Company entered into an amended and restated Product Supply Agreement (the Amended Supply Agreement), with Gambro Renal Products and Gambro AB. The Amended Supply Agreement effectively revoked the Company s notice of termination of the

Product Supply Agreement. The Amended Supply Agreement, among other things, relieves the Company of certain obligations, including releasing it from the purchase requirements of certain affected products during the import ban, permits the Company to secure alternate sources of supplies for the products affected by the import ban, reduces the Company s purchase obligations for certain hemodialysis product supplies and equipment and allows for the termination of the purchase obligations for equipment affected by the import ban if the import ban is not lifted by June 30, 2007.

As a result of the reductions in the amount of purchase obligations that are now required under the Amended Supply Agreement, the Company recorded a net valuation gain of $37,968. This valuation gain represents the difference in the fair value between the Product Supply Agreement and the Amended Supply Agreement, as of the effective date of the amendment.

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

9. Discontinued operations

Effective January 1, 2006, the Company completed the sale of three centers to Renal Advantage, Inc. that were pending state regulatory approval. These centers were part of the total number of outpatient dialysis centers that were divested in conjunction with the consent order issued by the Federal Trade Commission in order for the Company to complete the acquisition of DVA Renal Healthcare but were deferred until the Company obtained the required state regulatory approval. The Company received net cash of $17,518 for these three divested centers and recorded a loss of $311, net of tax, during the first quarter of 2006. The loss on disposal of these centers includes an income tax expense totaling $1,272, of which $900 is related to the write off of book goodwill not deductible for tax purposes.

Net assets as of January 1, 2006 of the three divested centers sold were as follows:

Current assets	$ 157
Property and equipment, net	1,050
Goodwill	15,382
Liabilities	(32)
Net assets from discontinued operations	$ 16,557

The results of operations of the total historical DaVita outpatient centers that were either divested or held for sale in 2005 are reflected as discontinued operations as follows:

	Three months ended September 30, 2005	Nine months ended September 30, 2005
Net operating revenues	$ 31,928	$ 95,222
Income before income taxes	7,042	22,069
Income tax	2,739	8,586
Income from discontinued operations	$ 4,303	$ 13,483

In the second quarter of 2006, the Company recorded a loss of $1,092, net of tax, as an adjustment to the previously reported gain on disposal of discontinued operations.

During the third quarter of 2006, the Company recorded a gain of $1,765 as an additional adjustment to the previously reported gain on disposal of discontinued operations as a result of a tax adjustment.

10. Significant new accounting standards

In June 2006, the Financial Accounting Standards Board issued Interpretation 48 (FIN 48) *Accounting for Income Tax Uncertainties*, which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with SFAS Statement No. 109 *Accounting for Income Taxes*. The Interpretation prescribes a recognition threshold of more-likely-than-not and a measurement attribute on all tax positions taken or expected to be taken in a tax return in order to be recognized in the financial statements. In making this assessment, a company must determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based solely on the technical merits of the position and that the tax position will be examined by appropriate taxing authority that

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

would have full knowledge of all relevant information. Once the recognition threshold is met, the tax position is then measured to determine the actual amount of benefit to recognize in the financial statements. In addition, the recognition threshold of more-likely-than-not must continue to be met in each reporting period to support continued recognition of the tax benefit. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the financial reporting period in which that threshold is no longer met. The Interpretation is effective for fiscal years beginning after December 15, 2006. The Company is assessing the expected impact of this Interpretation on its consolidated financial statements.

In September 2006, the U.S. Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, which provides interpretive guidance on how the effects of prior year misstatements should be considered in quantifying current year financial statement misstatements. The interpretations in SAB No. 108, which expresses the SEC s staff views, were issued to address the diversity in the practice of quantifying financial statement misstatements and the potential under current practice for a build up of improper amounts on the balance sheet. The SEC staff indicated that companies should quantify errors using both a balance sheet and an income statement approach and evaluate whether either approach results in material misstatement. SAB 108 is effective for fiscal years ending after November 15, 2006. The Company is assessing the expected impact of this SAB on its consolidated financial statements.

11. Condensed consolidating financial statements

The following information is presented in accordance with Rule 3-10 of Regulation S-X. The operating and investing activities of the separate legal entities included in the consolidated financial statements are fully interdependent and integrated. Revenues and operating expenses of the separate legal entities include intercompany charges for management and other services. The senior notes and the senior subordinated notes were issued by the Company and are guaranteed by substantially all of the Company s direct and indirect wholly-owned subsidiaries. Each of the guarantor subsidiaries has guaranteed the notes on a joint and several, full and unconditional basis. Non-wholly-owned subsidiaries, joint venture partnerships and other third parties are not guarantors of these obligations.

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

Condensed Consolidating Statements of Income

For the three months ended September 30, 2006	DaVita Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Net operating revenues	$ 88,592	$ 1,073,137	$ 168,763	$ (93,451)	$ 1,237,041
Operating expenses	45,868	926,000	130,574	(93,451)	1,008,991
Minority interests				10,956	10,956
Operating income	42,724	147,137	38,189	(10,956)	217,094
Debt (expense) income	9,854	(77,731)	(27)		(67,904)
Other income	3,271				3,271
Income tax expense	21,933	37,437			59,370
Discontinued operations, net of tax		1,765			1,765
Equity earnings in subsidiaries	60,940	27,206		(88,146)	
Net income	$ 94,856	$ 60,940	$ 38,162	$ (99,102)	$ 94,856
For the three months ended September 30, 2005					
Net operating revenues	$ 50,035	$ 530,241	$ 119,362	$ (54,746)	$ 644,892
Operating expenses	31,692	465,454	90,504	(54,746)	532,904
Minority interests				6,690	6,690
Operating income	18,343	64,787	28,858	(6,690)	105,298
Debt (expense) income and swap losses	(2,525)	(22,944)	(533)		(26,002)
Other income	2,059				2,059
Income tax expense	6,402	23,866	173		30,441
Discontinued operations, net of tax		2,292	2,011		4,303
Equity earnings in subsidiaries	43,742	23,473		(67,215)	
Net income	$ 55,217	$ 43,742	$ 30,163	$ (73,905)	$ 55,217

For the nine months ended September 30, 2006	DaVita Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Net operating revenues	$ 252,963	$ 3,153,982	$ 469,817	$ (268,717)	$ 3,608,045
Operating expenses	138,341	2,784,676	375,967	(268,717)	3,030,267

Minority interests				26,857	26,857
Operating income	114,622	369,306	93,850	(26,857)	550,921
Debt (expense) income	27,877	(233,749)	(927)		(206,799)
Other income	10,118				10,118
Income tax expense	59,673	79,321	46		139,040
Discontinued operations, net of tax		362			362
Equity earnings in subsidiaries	122,618	66,020		(188,638)	
Net income	$ 215,562	$ 122,618	$ 92,877	$ (215,495)	$ 215,562
For the nine months ended September 30, 2005					
Net operating revenues	$ 146,615	$ 1,549,789	$ 304,627	$ (160,428)	$ 1,840,603
Operating expenses	92,259	1,344,313	241,686	(160,428)	1,517,830
Minority interests				16,184	16,184
Operating income	54,356	205,476	62,941	(16,184)	306,589
Debt (expense) income, refinancing charges and swap gains	(3,094)	(64,224)	(1,711)		(69,029)
Other income	5,741				5,741
Income tax expense	21,661	70,090	539		92,290
Discontinued operations, net of tax		7,515	5,968		13,483
Equity earnings in subsidiaries	129,152	50,475		(179,627)	
Net income	$ 164,494	$ 129,152	$ 66,659	$ (195,811)	$ 164,494

20

Table of Contents

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

Condensed Consolidating Balance Sheets

As of September 30, 2006	DaVita Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Cash and cash equivalents	$ 260,278	$	$		$ 260,278
Accounts receivable, net		785,782	116,963		902,745
Other current assets	12,302	443,871	(6,438)		449,735
Total current assets	272,580	1,229,653	110,525		1,612,758
Property and equipment, net	42,267	656,796	113,992		813,055
Amortizable intangibles, net	64,897	147,624	1,973		214,494
Investments in subsidiaries	3,840,758	385,220		$ (4,225,978)	
Receivables from subsidiaries	849,848		68,705	(918,553)	
Other long-term assets and investments	27,642	2,889	15,937		46,468
Goodwill		3,435,583	221,772		3,657,355
Total assets	$ 5,097,992	$ 5,857,765	$ 532,904	$ (5,144,531)	$ 6,344,130
Current liabilities	$ 124,796	$ 860,094	$ 25,467		$ 1,010,357
Payables to parent and subsidiaries		918,553		$ (918,553)	
Long-term debt and other long-term liabilities	3,826,384	238,360	10,495		4,075,239
Minority interests				111,722	111,722
Shareholders equity	1,146,812	3,840,758	496,942	(4,337,700)	1,146,812
Total liabilities and shareholders equity	$ 5,097,992	$ 5,857,765	$ 532,904	$ (5,144,531)	$ 6,344,130

As of December 31, 2005	DaVita Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Cash and cash equivalents	$ 431,811	$	$		$ 431,811
Accounts receivable, net		749,288	104,272		853,560
Other current assets	5,877	350,035	13,125		369,037
Total current assets	437,688	1,099,323	117,397		1,654,408
Property and equipment, net	34,319	611,828	103,931		750,078
Amortizable intangibles, net	73,407	158,980	3,557		235,944
Investments in subsidiaries	3,616,683	333,106		$ (3,949,789)	
Receivables from subsidiaries	1,038,182		8,486	(1,046,668)	
Other long-term assets and investments	30,273	4,933	9,743		44,949
Goodwill		3,399,112	195,271		3,594,383

Total assets	$ 5,230,552	$ 5,607,282	$ 438,385	$ (4,996,457)	$ 6,279,762
Current liabilities	$ 285,956	$ 691,172	$ 12,605		$ 989,733
Payables to parent and subsidiaries		1,046,668		$ (1,046,668)	
Long-term debt and other long-term liabilities	4,093,987	252,759	4,035		4,350,781
Minority interests				88,639	88,639
Shareholders equity	850,609	3,616,683	421,745	(4,038,428)	850,609
Total liabilities and shareholders equity	$ 5,230,552	$ 5,607,282	$ 438,385	$ (4,996,457)	$ 6,279,762

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars in thousands, except per share data)

Condensed Consolidating Statements of Cash Flows

For the nine months ended September 30, 2006	DaVita Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Cash flows from operating activities					
Net income	$ 215,562	$ 122,618	$ 92,877	$ (215,495)	$ 215,562
Changes in operating and intercompany assets and liabilities and non cash items included in net income	(112,901)	136,633	(125,326)	215,495	113,901
Net cash provided by (used in) operating activities	102,661	259,251	(32,449)		329,463
Cash flows from investing activities					
Additions of property and equipment, net	(13,024)	(142,600)	(25,801)		(181,425)
Acquisitions and purchases of other ownership interests		(75,580)			(75,580)
Proceeds from divestitures and asset sales	12,742	8,606			21,348
Other items		(48,657)	57,513		8,856
Net cash (used in) provided by investing activities	(282)	(258,231)	31,712		(226,801)
Cash flows from financing activities					
Long-term debt	(332,541)	(1,020)	737		(332,824)
Other items	58,629				58,629
Net cash (used in) provided by financing activities	(273,912)	(1,020)	737		(274,195)
Net decrease in cash and cash equivalents	(171,533)				(171,533)
Cash and cash equivalents at beginning of period	431,811				431,811
Cash and cash equivalents at end of period	$ 260,278	$	$	$	$ 260,278

For the nine months ended September 30, 2005	DaVita Inc.	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Cash flows from operating activities					
Net income	$ 164,494	$ 129,152	$ 66,659	$ (195,811)	$ 164,494
	(76,623)	107,133	(88,605)	195,811	137,716

Changes in operating and intercompany assets and liabilities and non cash items included in net income					
Net cash provided by (used in) operating activities	87,871	236,285	(21,946)		302,210
Cash flows from investing activities					
Additions of property and equipment, net	(1,958)	(57,689)	(37,882)		(97,529)
Acquisitions and purchases of other ownership interests		(132,440)			(132,440)
Proceeds from divestitures and asset sales		2,327			2,327
Other items		(44,321)	57,836		13,515
Net cash (used in) provided by investing activities	(1,958)	(232,123)	19,954		(214,127)
Cash flows from financing activities					
Long-term debt	(8,748)	(4,162)	1,992		(10,918)
Other items	8,052				8,052
Net cash (used in) provided by financing activities	(696)	(4,162)	1,992		(2,866)
Net increase in cash and cash equivalents	85,217				85,217
Cash and cash equivalents at beginning of period	251,979				251,979