WRIGHT MEDICAL GROUP INC
Form 10-Q
July 29, 2011

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UNITED STATES
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 June 30, 2011

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: 000-32883

WRIGHT MEDICAL GROUP, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**13-4088127**
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)
5677 Airline Road Arlington, Tennessee	**38002**
(Address of Principal Executive Offices)	(Zip Code)

(901) 867-9971

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. þ Yes o 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.) þ Yes o 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 smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if smaller reporting company)	Smaller Reporting Company o

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

As of July 25, 2011, there were 39,404,443 shares of common stock outstanding.

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SAFE-HARBOR STATEMENT

This quarterly report contains forward-looking statements as defined under U.S. federal securities laws. These statements, including statements regarding potential actions by the United States Attorney s Office for the District of New Jersey, independent monitor, Office of Inspector General and other agencies or their potential impact, reflect management s current knowledge, assumptions, beliefs, estimates, and expectations and express management s current views of future performance, results, and trends and may be identified by their use of terms such as anticipate, believe, could, estimate, expect, intend, may, plan, predict, project, will, and other similar terms. Forward-lo are subject to a number of risks and uncertainties that could cause our actual results to materially differ from those described in the forward-looking statements. Readers should not place undue reliance on forward-looking statements. Such statements are made as of the date of this quarterly report, and we undertake no obligation to update such statements after this date.

Risks and uncertainties that could cause our actual results to materially differ from those described in forward-looking statements include those discussed in our filings with the Securities and Exchange Commission (including those described in Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2010, under the heading, Risk Factors and in Item 1A of Part II and elsewhere in this report), and the following:

the impact of our settlement of the federal investigation into our consulting arrangements with orthopaedic surgeons relating to our hip and knee products in the United States, including our compliance with the Deferred

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Prosecution Agreement (DPA) through September 2011 (which could be extended) and the Corporate Integrity Agreement (CIA) through September 2015. Our failure to comply with the DPA or the CIA could expose us to significant liability including, but not limited to, extension of the term of the DPA, exclusion from federal healthcare program participation, including Medicaid and Medicare, which would have a material adverse effect on our financial condition, results of operations and cash flows, potential prosecution, including under the previously-filed criminal complaint, civil and criminal fines and penalties, and additional litigation cost and expense. A breach of the DPA or the CIA could result in an event of default under the Senior Credit Facility, which in turn could result in an event of default under the Indenture;

the possibility of litigation brought by shareholders, including private securities litigation and shareholder derivative suits, which, if initiated, could divert management s attention, harm our business and/or reputation and result in significant liabilities;

demand for and market acceptance of our new and existing products;

recently enacted healthcare reform legislation and its future implementation, possible additional legislation, regulation and other governmental pressures in the United States or globally, which may affect pricing, reimbursement, taxation and rebate policies of government agencies and private payers or other elements of our business;

tax reform measures, tax authority examinations and associated tax risks and potential obligations;

our ability to identify business development and growth opportunities for existing or future products;

product quality or patient safety issues, leading to product recalls, withdrawals, launch delays, sanctions, seizures, litigation, or declining sales;

individual, group or class action alleging products liability claims, including an increase in the number of claims during any period;

future actions of the FDA or any other regulatory body or government authority that could delay, limit or suspend product development, manufacturing or sale or result in seizures, injunctions, monetary sanctions or criminal or civil liabilities;

our ability to enforce our patent rights or patents of third parties preventing or restricting the manufacture, sale or use of affected products or technology;

the impact of geographic and product mix on our sales;

retention of our sales representatives and independent distributors;

inventory reductions or fluctuations in buying patterns by wholesalers or distributors;

our ability to realize the anticipated benefits of restructuring initiatives; and

any impact of the commercial and credit environment on us and our customers and suppliers.

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (unaudited).

WRIGHT MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)
(unaudited)

	June 30, 2011	December 31, 2010
Assets:		
Current assets:		
Cash and cash equivalents	$ 159,427	$ 153,261
Marketable securities	14,997	19,152
Accounts receivable, net	107,125	105,336
Inventories	171,544	166,339
Prepaid expenses	5,579	5,333
Deferred income taxes	32,178	32,026
Other current assets	13,550	16,143
Total current assets	504,400	497,590
Property, plant and equipment, net	164,709	158,247
Goodwill	54,837	54,172
Intangible assets, net	15,436	16,501
Marketable securities	10,838	17,193
Deferred income taxes	4,245	4,125
Other assets	6,404	7,411
Total assets	$ 760,869	$ 755,239
Liabilities and Stockholders Equity:		
Current liabilities:		
Accounts payable	$ 18,173	$ 15,862
Accrued expenses and other current liabilities	55,314	54,409
Current portion of long-term obligations	8,627	1,033
Total current liabilities	82,114	71,304
Long-term debt and capital lease obligations	171,104	201,766
Deferred income taxes	6,519	5,705
Other liabilities	12,143	5,492
Total liabilities	$ 271,880	$ 284,267
Commitments and contingencies (Note 11)		
Stockholders equity:		
	383	379

Common stock, $.01 par value, authorized: 100,000,000 shares; issued and outstanding: 39,403,820 shares at June 30, 2011 and 39,171,501 shares at December 31, 2010		
Additional paid-in capital	394,327	390,098
Accumulated other comprehensive income	26,218	22,173
Retained earnings	68,061	58,322
Total stockholders equity	488,989	470,972
Total liabilities and stockholders equity	$ 760,869	$ 755,239

The accompanying notes are an integral part of these condensed consolidated financial statements.

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WRIGHT MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Net sales	$ 132,505	$ 127,734	$ 267,891	$ 258,978
Cost of sales [1]	41,504	39,934	80,272	80,075
Gross profit	91,001	87,800	187,619	178,903
Operating expenses:				
Selling, general and administrative [1]	70,821	67,774	145,646	144,212
Research and development [1]	7,807	9,784	17,014	19,619
Amortization of intangible assets	677	634	1,367	1,283
Restructuring charges		461		1,005
Total operating expenses	79,305	78,653	164,027	166,119
Operating income	11,696	9,147	23,592	12,784
Interest expense, net	1,475	1,510	3,310	3,018
Other expense (income), net	257	(175)	4,716	(43)
Income before income taxes	9,964	7,812	15,566	9,809
Provision for income taxes	3,817	2,965	5,827	5,487
Net income	$ 6,147	$ 4,847	$ 9,739	$ 4,322
Net income per share (Note 9):				
Basic	$ 0.16	$ 0.13	$ 0.26	$ 0.11
Diluted	$ 0.16	$ 0.13	$ 0.25	$ 0.11
Weighted-average number of shares outstanding-basic	38,240	37,764	38,137	37,652
Weighted-average number of shares outstanding-diluted	39,261	37,960	38,347	37,884

1 These line items include the following amounts of non-cash, stock-based compensation expense for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Cost of sales	$ 360	$ 326	$ 707	$ 666

Selling, general and administrative	1,300	3,172	3,368	5,439
Research and development	(53)	610	392	1,008

The accompanying notes are an integral part of these condensed consolidated financial statements.

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WRIGHT MEDICAL GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(unaudited)

	Six Months Ended June 30, 2011	Six Months Ended June 30, 2010
Operating activities:		
Net income	$ 9,739	$ 4,322
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	19,238	16,970
Stock-based compensation expense	4,467	7,113
Amortization of intangible assets	1,367	1,283
Amortization of deferred financing costs	558	493
Deferred income taxes	431	(2,420)
Write off of deferred financing costs	2,926	
Excess tax benefit from stock-based compensation arrangements	(37)	(283)
Non-cash restructuring charges		248
Other	(1,411)	953
Changes in assets and liabilities (net of acquisitions):		
Accounts receivable	2,130	(2,777)
Inventories	(4,819)	(1,335)
Prepaid expenses and other current assets	2,732	5,187
Accounts payable	2,124	5,093
Accrued expenses and other liabilities	(429)	11,847
Net cash provided by operating activities	39,016	46,694
Investing activities:		
Capital expenditures	(23,376)	(22,377)
Acquisitions of businesses		(2,072)
Purchase of intangible assets	(361)	(1,001)
Sales and maturities of available-for-sale marketable securities	17,908	44,692
Investment in available-for-sale marketable securities	(7,337)	(50,307)
Proceeds from sale of assets	5,500	
Net cash used in investing activities	(7,666)	(31,065)
Financing activities:		
Issuance of common stock	271	452
Financing under factoring agreement, net		5
Payments of long term borrowings	(2,463)	(827)
Redemption of convertible senior notes	(170,889)	
Proceeds from term loan borrowings	150,000	
Payments of deferred financing costs	(2,887)	
Excess tax benefit from stock-based compensation arrangements	37	283
Net cash used in financing activities	(25,931)	(87)

Effect of exchange rates on cash and cash equivalents	747	(631)
Net increase in cash and cash equivalents	6,166	14,911
Cash and cash equivalents, beginning of period	153,261	84,409
Cash and cash equivalents, end of period	$ 159,427	$ 99,320

The accompanying notes are an integral part of these condensed consolidated financial statements.

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WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Summary of Significant Accounting Policies

Basis of Presentation. The unaudited condensed consolidated interim financial statements of Wright Medical Group, Inc. have been prepared in accordance with accounting principles generally accepted in the United States (U.S.) for interim financial information and the instructions to Quarterly Report on Form 10-Q and Rule 10-01 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the U.S. have been condensed or omitted pursuant to these rules and regulations. Accordingly, these unaudited condensed consolidated interim financial statements should be read in conjunction with our consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended December 31, 2010, as filed with the U.S. Securities and Exchange Commission (SEC).

In the opinion of management, these unaudited condensed consolidated interim financial statements reflect all adjustments necessary for a fair presentation of our interim financial results. All such adjustments are of a normal and recurring nature. The results of operations for any interim period are not indicative of results for the full fiscal year.

The accompanying unaudited condensed consolidated interim financial statements include our accounts and those of our wholly-owned domestic and international subsidiaries. Intercompany accounts and transactions have been eliminated in consolidation.

The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent liabilities at the dates of the financial statements and the amounts of revenues and expenses during the reporting periods. Actual amounts realized or paid could differ from those estimates.

Revenue Recognition. Our revenues are primarily generated through two types of customers, hospitals and surgery centers, and stocking distributors, with the majority of our revenue derived from sales to hospitals. Our products are primarily sold through a network of employee sales representatives and independent sales representatives in the U.S. and by a combination of employee sales representatives, independent sales representatives, and stocking distributors outside the U.S. Revenues from sales to hospitals are recorded when the hospital takes title to the product, which is generally when the product is surgically implanted in a patient. We record revenues from sales to our stocking distributors outside the U.S. at the time the product is shipped to the stocking distributor.

In 2011, we entered into a trademark license agreement (License Agreement) with KCI Medical Resources, a subsidiary of Kinetic Concepts, Inc (KCI). The License Agreement provides KCI Medical Resources with a non-transferable license to use our trademarks associated with our GRAFTJACKET® line of products in connection with the marketing and distribution of KCI Medical Resources soft tissue graft containment products used in the wound care field, subject to certain exceptions. License revenue is being recognized over the life of the agreement on a straight line basis.

Derivative Instruments. We account for derivative instruments and hedging activities under Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) Topic 815, *Derivatives and Hedging* (FASB ASC 815). Accordingly, all of our derivative instruments are recorded in the accompanying condensed consolidated balance sheets as either an asset or liability and are measured at fair value. The changes in the derivative s fair value are recognized currently in earnings unless specific hedge accounting criteria are met.

We employ a derivative program using 30-day foreign currency forward contracts to mitigate the risk of currency fluctuations on our intercompany receivable and payable balances that are denominated in foreign currencies. These forward contracts are expected to offset the transactional gains and losses on the related intercompany balances. These forward contracts are not designated as hedging instruments under FASB ASC 815. Accordingly, the changes in the fair value and the settlement of the contracts are recognized in the period incurred in the accompanying consolidated statements of operations.

Additionally, we entered into an interest rate swap to hedge a portion of our variable interest rate obligations. The interest rate swap has been accounted for as a cash flow hedge in accordance with FASB ASC Topic 815. See Note 6 for further disclosure on our interest rate swap.

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WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
(UNAUDITED)

Fair Value of Financial Instruments and Immaterial Error Correction. The carrying values of cash and cash equivalents, accounts receivable, and accounts payable approximate the fair values of these financial instruments as of June 30, 2011 and December 31, 2010 due to their short maturities.

The carrying amount of debt outstanding pursuant to our credit facility approximates fair value as interest rates on these instruments approximate current market rates. See Note 5 for additional information regarding the credit facility.

The $29.1 million of our convertible senior notes are carried at cost. The estimated fair value of the senior notes was approximately $28.2 million at June 30, 2011 based on a limited number of trades and does not necessarily represent the value at which the entire convertible note portfolio can be retired.

Pursuant to the requirements of the FASB ASC Topic 820, *Fair Value Measurements and Disclosures,* our financial assets and liabilities measured at fair value on a recurring basis are classified and disclosed in one of the following three categories:

Level 1: Financial instruments with unadjusted, quoted prices listed on active market exchanges.

Level 2: Financial instruments determined using prices for recently traded financial instruments with similar underlying terms as well as directly or indirectly observable inputs, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3: Financial instruments that are not actively traded on a market exchange. This category includes situations where there is little, if any, market activity for the financial instrument. The prices are determined using significant unobservable inputs or valuation techniques.

We use a third-party provider to determine fair values of our available-for-sale marketable securities. The third-party provider receives market prices for each marketable security from a variety of industry standard data providers, security master files from large financial institutions and other third-party sources with reasonable levels of price transparency. The third-party provider uses these multiple prices as inputs into a pricing model to determine a weighted average price for each security. We classify our U.S. Treasury bills and bonds as Level 1 based upon quoted prices in active markets. All other marketable securities are classified as Level 2 based upon the other than quoted prices with observable market data. These include municipal debt securities, U.S agency debt securities, corporate debt securities, certificates of deposits and time deposits. During the three months ended March 31, 2011, we began investing in commercial paper with original maturity dates of three months or less. Our commercial paper is classified as a Level 2 and is included in our Cash and cash equivalents balance as of June 30, 2011.

During the quarter ended March 31, 2011, we corrected an immaterial error in the footnotes to our 2010 Form 10-K related to the fair value hierarchy classification of certain available for sale marketable securities. As of December 31, 2010, municipal debt securities, U.S. agency debt securities, and corporate debt securities with fair values of $897,000, $14.5 million, and $3.2 million, respectively, all of which are Level 2 fair value measurements, were incorrectly classified as Level 1 fair value measurements. The table below has been corrected to reflect the appropriate fair value hierarchy classification as of December 31, 2010. This error is not considered material to the 2010 consolidated financial statements.

As part of the acquisition of EZ Concepts Surgical Device Corporation, d/b/a EZ Frame, completed in 2010, we may be obligated to pay contingent consideration of up to $400,000 upon the achievement of certain revenue milestones. The $356,000 fair value of the contingent consideration was determined using a discounted cash flow model and probability adjusted estimates of the future earnings and is classified in Level 3. This obligation is included in current liabilities in our condensed consolidated balance sheet. Changes in the fair value of contingent consideration will be recorded in our consolidated statements of operations.

WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
(UNAUDITED)

The following table summarizes the valuation of our financial instruments measured at fair value on a recurring basis (in thousands):

	Total	Quoted Prices in Active Markets (Level 1)	Prices with Other Observable Inputs (Level 2)	Prices with Unobservable Inputs (Level 3)
At June 30, 2011				
Assets				
Cash and cash equivalents	$ 159,427	$ 109,435	$ 49,992	$
Available-for-sale marketable securities				
Municipal debt securities	$ 517	$	$ 517	$
U.S. agency debt securities	3,503		3,503	
Corporate debt securities	9,477		9,477	
U.S. government debt securities	7,522	7,522		
Total available-for-sale marketable securities	21,019	7,522	13,497	
Held-to-maturity time deposits	4,816		4,816	
	$ 185,262	$ 116,957	$ 68,305	$
Liabilities				
Interest rate swap	$ 706	$	$ 706	$
Contingent consideration	356			356
	$ 1,062	$	$ 706	$ 356

	Total	Quoted Prices in Active Markets (Level 1)	Prices with Other Observable Inputs (Level 2)	Prices with Unobservable Inputs (Level 3)
At December 31, 2010				
Assets				
Cash and cash equivalents	$ 153,261	$ 153,261	$	$

Available-for-sale marketable securities				
Municipal debt securities	$ 897	$	$ 897	$
U.S. agency debt securities	14,511		14,511	
Certificates of deposits	38		38	
Corporate debt securities	3,183		3,183	
U.S. government debt securities	13,045	13,045		
Total available-for-sale marketable securities	31,674	13,045	18,629	
Held-to-maturity time deposits	4,671		4,671	
	$ 189,606	$ 166,306	$ 23,300	$
Liabilities				
Contingent consideration	$ 356	$	$	$ 356
	$ 356	$	$	$ 356

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WRIGHT MEDICAL GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)
(UNAUDITED)

2. Inventories

Inventories consist of the following (in thousands):

	June 30, 2011	December 31, 2010
Raw materials	$ 9,029	$ 8,962