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BIOMET INC
Form 10-Q
January 10, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended November 30, 2004.

OR

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

For the transition period from _____ to _____.

Commission file Number 0-12515.

BIOMET, INC.
(Exact name of registrant as specified in its charter)

Indiana
(State or other jurisdiction of
incorporation or organization)

35-1418342
(I.R.S. Employer
Identification No.)

56 East Bell Drive, Warsaw, Indiana 46582
(Address of principal executive offices)

(574) 267-6639
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports), and (2) has been subject to such
filing requirements for the past 90 days. Yes No

As of November 30, 2004, the registrant had 252,677,803 common shares
outstanding.

BIOMET, INC.

CONTENTS

Pages

Part I. Financial Information

Item 1. Financial Statements:

Consolidated Balance Sheets	1-2
Consolidated Statements of Income	3

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Consolidated Statements of Cash Flows	4
Notes to Consolidated Financial Statements	5-9
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	10-12
Item 3. Quantitative and Qualitative Disclosure about Market Risks	13
Item 4. Controls and Procedures	13
Part II. Other Information	14
Signatures	15
Index to Exhibits	16

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

BIOMET, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
at November 30, 2004 and May 31, 2004
(in thousands)

ASSETS

	November 30, 2004	May 31, 2004
	-----	-----
	(Unaudited)	
Current assets:		
Cash and cash equivalents	\$ 99,518	\$ 159,243
Investments	10,907	10,030
Accounts and notes receivable, net	476,574	465,949
Inventories	446,711	389,391
Deferred income taxes	85,748	69,379
Prepaid expenses and other	29,674	21,877
	-----	-----
Total current assets	1,149,132	1,115,869
	-----	-----
Property, plant and equipment, at cost	527,423	466,460
Less, Accumulated depreciation	228,626	197,634
	-----	-----
Property, plant and equipment, net	298,797	268,826
	-----	-----
Investments	63,880	66,339
Goodwill, net	439,335	266,860
Intangible assets, net	90,335	53,571
Other assets	16,261	16,232
	-----	-----
Total assets	\$2,057,740	\$1,787,697
	=====	=====

The accompanying notes are a part of the consolidated financial statements.

BIOMET, INC. AND SUBSIDIARIES

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CONSOLIDATED BALANCE SHEETS
at November 30, 2004 and May 31, 2004
(in thousands)

LIABILITIES AND SHAREHOLDERS' EQUITY

	November 30, 2004	May 31, 2004
	-----	-----
	(Unaudited)	
Current liabilities:		
Short-term borrowings	\$ 324,676	\$ 109,654
Accounts payable	55,548	55,365
Accrued income taxes	10,013	18,940
Accrued wages and commissions	50,707	51,288
Other accrued expenses	104,558	78,155
	-----	-----
Total current liabilities	545,502	313,402
Long-term liabilities:		
Deferred income taxes	34,981	26,085
	-----	-----
Total liabilities	580,483	339,487
	-----	-----
Contingencies (Note 9)		
Shareholders' equity:		
Common shares	178,585	167,301
Additional paid-in capital	60,720	60,344
Retained earnings	1,217,538	1,218,682
Accumulated other comprehensive income	20,414	1,883
	-----	-----
Total shareholders' equity	1,477,257	1,448,210
	-----	-----
Total liabilities and shareholders' equity	\$2,057,740	\$1,787,697
	=====	=====

The accompanying notes are a part of the consolidated financial statements.

BIOMET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
for the six and three month periods ended November 30, 2004 and 2003
(Unaudited, in thousands, except per share data)

	Six Months Ended		Three Months Ended	
	2004	2003	2004	2003
	----	----	----	----
Net sales	\$ 894,834	\$ 757,880	\$456,674	\$387,561
Cost of sales	257,087	214,408	131,115	108,790
	-----	-----	-----	-----
Gross profit	637,747	543,472	325,559	278,771
Selling, general and administrative expenses	326,765	269,061	166,305	136,664
Research and development expense	38,082	30,558	19,606	15,810
In-process research and development	26,020	--	--	--
	-----	-----	-----	-----

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Operating income	246,880	243,853	139,648	126,297
Other income, net	(484)	6,690	244	3,669
	-----	-----	-----	-----
Income before income taxes and minority interest	246,396	250,543	139,892	129,966
Provision for income taxes	94,764	87,229	48,693	45,250
	-----	-----	-----	-----
Income before minority interest	151,632	163,314	91,911	84,716
Minority interest	--	4,144	--	2,024
	-----	-----	-----	-----
Net income	\$ 151,632	\$ 159,170	\$ 91,199	\$ 82,692
	=====	=====	=====	=====
Earnings per share:				
Basic	\$.60	\$.62	\$.36	\$.32
	=====	=====	=====	=====
Diluted	\$.59	\$.62	\$.36	\$.32
	=====	=====	=====	=====
Shares used in the computation of earnings per share:				
Basic	253,403	256,325	252,944	255,797
	=====	=====	=====	=====
Diluted	255,586	257,904	255,225	257,599
	=====	=====	=====	=====
Cash dividends per common share	\$.20	\$.15	\$ --	\$ --
	=====	=====	=====	=====

The accompanying notes are a part of the consolidated financial statements.

BIOMET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
for the six months ended November 30, 2004 and 2003
(Unaudited, in thousands)

	2004	2003
	----	----
Cash flows from (used in) operating activities:		
Net income	\$151,632	\$159,170
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation	28,969	24,036
Amortization	3,290	1,512
Write off of in-process research and development	26,020	--
Loss (Gain) on sale of investments, net	223	(692)
Minority interest	--	4,144
Deferred income taxes	(6,684)	(1,103)
Changes in current assets and liabilities:		
Accounts and notes receivable, net	7,724	(16,819)
Inventories	(19,005)	(9,799)
Accounts payable	(3,868)	(7,089)
Accrued income taxes	(7,985)	(2,620)
Other	(1,133)	(1,425)
	-----	-----
Net cash from operating activities	179,183	149,315
	-----	-----
Cash flows from (used in) investing activities:		
Proceeds from sales and maturities of investments	24,692	68,981
Purchases of investments	(22,284)	(77,237)
Capital expenditures	(43,511)	(24,618)
Acquisitions, net of cash acquired	(266,229)	--

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Other	(3,131)	(1,878)
	-----	-----
Net cash used in investing activities	(310,463)	(34,752)
	-----	-----
Cash flows from (used in) financing activities:		
Increase in short-term borrowings, net	209,385	6,877
Issuance of common shares	12,766	13,323
Cash dividends	(50,872)	(38,604)
Purchase of common shares	(103,990)	(78,703)
	-----	-----
Net cash from (used in) financing activities	67,289	(97,107)
	-----	-----
Effect of exchange rate changes on cash	4,266	(1,366)
	-----	-----
Increase (decrease) in cash and cash equivalents	(59,725)	16,090
Cash and cash equivalents, beginning of year	159,243	225,650
	-----	-----
Cash and cash equivalents, end of period	\$ 99,518	\$241,740
	=====	=====

The accompanying notes are a part of the consolidated financial statements.

BIOMET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: BASIS OF PRESENTATION.

The accompanying consolidated financial statements include the accounts of Biomet, Inc. and its subsidiaries (individually and collectively referred to as the "Company"). The unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six-month period ended November 30, 2004 are not necessarily indicative of the results that may be expected for the fiscal year ending May 31, 2005. For further information, refer to the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended May 31, 2004.

The accompanying consolidated balance sheet at May 31, 2004, has been derived from the audited Consolidated Financial Statements at that date, but does not include all disclosures required by accounting principles generally accepted in the United States.

The Company operates in one business segment, musculoskeletal products, which includes the designing, manufacturing and marketing of reconstructive products, fixation devices, spinal products and other products. Other products consist primarily of EBI's softgoods and bracing products, Arthrotek's arthroscopy products, general instruments and operating room supplies. The Company manages its business segment primarily on a geographic basis. These geographic markets are comprised of the United States, Europe and the Rest of World. Major markets included in the Rest of World geographic market are Canada, South America, Mexico, Japan and the Pacific Rim.

Net sales of musculoskeletal products by product category are as follows for the six and three month periods ended November 30, 2004 and 2003:

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	Six Months Ended		Three Months Ended	
	2004	2003	2004	2003
	(in thousands)			
Reconstructive	\$583,867	\$485,522	\$301,385	\$252,083
Fixation	123,041	122,428	60,328	60,295
Spinal products	106,141	76,946	53,232	38,979
Other	81,785	72,984	41,729	36,204
	\$894,834	\$757,880	\$456,674	\$387,561
	=====	=====	=====	=====

As permitted by SFAS No. 123, the Company accounts for its employee stock options using the intrinsic value method. Accordingly, no compensation expense is recognized for the employee stock-based compensation plans. If compensation expense for the Company's employee stock options had been determined based on the fair value method of accounting, pro forma net income and diluted earnings per share for the six and three month periods ended November 30, 2004 and 2003 would have been as follows:

	Six Months Ended		Three Months Ended	
	2004	2003	2004	2003
Net income as reported (in thousands)	\$151,632	\$159,170	\$ 91,199	\$ 82,692
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards net of related tax effects (in thousands)	3,034	2,563	1,501	1,281
Pro forma net income (in thousands)	\$148,598	\$156,607	\$ 89,698	\$ 81,411
	=====	=====	=====	=====
Earning per share:				
Basic, as reported	\$0.60	\$0.62	\$0.36	\$0.32
	=====	=====	=====	=====
Basic, pro forma	\$0.59	\$0.61	\$0.35	\$0.32
	=====	=====	=====	=====
Diluted, as reported	\$0.59	\$0.62	\$0.36	\$0.32
	=====	=====	=====	=====
Diluted, pro forma	\$0.58	\$0.61	\$0.35	\$0.32
	=====	=====	=====	=====

On December 16, 2004, the FASB finalized SFAS No. 123R "Share-Based Payment," which will be effective for interim or annual reporting periods beginning after June 15, 2005. The new standard will require us to expense stock options and the FASB believes the use of a binomial lattice model for option valuation is capable of more fully reflecting certain characteristics of employee share options. The Company has begun a process to analyze how the utilization of a binomial lattice model could impact the valuation of our options. The effect of expensing stock options on our results of operations using the Black-Scholes model is presented in the table above.

NOTE 2: BUSINESS COMBINATION.

On June 18, 2004, the Company, through its EBI subsidiary, acquired Interpore International, Inc. (Interpore) for \$270.5 million in cash. The primary reason for making the Interpore acquisition was to broaden the product portfolio the Company offers in the spinal market. The Company accounted for this acquisition

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as a purchase, and the operating results of Interpore have been consolidated from the date of acquisition. Interpore's respective assets and liabilities have been recorded at their estimated fair values in the Company's financial statements, with the excess purchase price being allocated to goodwill.

The Company completed its initial purchase price allocation in accordance with U.S. generally accepted accounting principles. The process included interviews with Interpore management, review of the economic and competitive environment in which Interpore operates and examination of assets, including historical performance and future prospects. The purchase price allocation was based on information currently available to the Company, and expectations and assumptions deemed reasonable to the Company's management. No assurances can be given, however, that the underlying assumptions used to estimate expected technology based product revenue, development costs or profitability, or the events associated with such technology, will occur as projected.

The following table summarizes the estimated fair values of the assets acquired and liabilities assumed in the acquisition:

	As of June 16, 2004

Current assets	\$ 60,316
Property, plant and equipment	9,307
Intangible assets not subject to amortization:	
Trademarks and trade names	1,260
Intangible assets subject to amortization:	
Trademarks and trade names	2,270
Developed technology	16,180
Distribution and sales agreements	11,440
License agreements	3,450
In-process research and development	26,020
Other assets	83
Goodwill	169,596

Total assets acquired	299,922

Deferred taxes	14,512
Other current liabilities	14,909

Total liabilities assumed	29,421

Net assets acquired	\$270,501
	=====

The \$26,020,000 assigned to in-process research and development was written off as of the acquisition date. The weighted average amortization period for amortizable intangibles is 10 years. No amount of goodwill is expected to be deductible for tax purposes. Pro forma financial information reflecting this acquisition has not been presented as it is not materially different from the Company's historical results.

NOTE 3: COMPREHENSIVE INCOME.

Other comprehensive income includes foreign currency translation adjustments and unrealized appreciation of available-for-sale securities, net of taxes. Other comprehensive income for the three months ended November 30, 2004 and 2003 was \$17,069,000 and \$9,884,000, respectively. Other comprehensive income for the six months ended November 30, 2004 and 2003 was \$18,531,000 and \$12,483,000, respectively. Total comprehensive income combines reported net income and other comprehensive income. Total comprehensive income for the

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three months ended November 30, 2004 and 2003 was \$108,268,000 and \$92,576,000, respectively. Total comprehensive income for the six months ended November 30, 2004 and 2003 was \$170,163,000 and \$171,653,000, respectively.

NOTE 4: INVENTORIES.

Inventories at November 30, 2004 and May 31, 2004 are as follows:

	November 30, 2004	May 31, 2004
	-----	-----
	(in thousands)	
Raw materials	\$ 43,352	\$ 34,075
Work-in-process	50,267	43,187
Finished goods	189,007	163,299
Consigned inventory	164,085	148,830
	-----	-----
	\$446,711	\$389,391
	=====	=====

NOTE 5: DEBT.

In connection with the Interpore acquisition, the Company entered into a 36 month revolving credit facility in the amount of \$200 million. Interest is payable at LIBOR plus 0.5%. At November 30, 2004, \$200 million was outstanding and the interest rate was 2.68%.

NOTE 6: COMMON SHARES.

During the six months ended November 30, 2004, the Company issued 743,908 Common Shares upon the exercise of outstanding stock options for proceeds aggregating \$12,766,000. Purchases of Common Shares pursuant to the Common Share Repurchase Programs aggregated 2,328,400 shares for \$103,990,000 during the six months ended November 30, 2004.

NOTE 7: EARNINGS PER SHARE.

Earnings per common share amounts ("basic EPS") are computed by dividing net income by the weighted average number of common shares outstanding and excludes any potential dilution. Earnings per common share amounts assuming dilution ("diluted EPS") are computed by reflecting potential dilution from the exercise of stock options.

NOTE 8: INCOME TAXES.

The difference between the reported provision for income taxes and a provision computed by applying the federal statutory rate to pre-tax accounting income is primarily attributable to state income taxes, tax benefits relating to operations in Puerto Rico, tax-exempt income, tax credits and the write-off of in-process research and development which is not tax affected.

NOTE 9: CONTINGENCIES.

On October 3, 2002, a complaint was filed against the Company by Spinal Concepts, Inc. ("Spinal Concepts") alleging that certain U.S. Patents owned by Spinal Concepts are infringed by the VueLock(R) Anterior Cervical Plate System manufactured by EBI, L.P. ("EBI"). On June 28, 2004, the Company's subsidiary, Cross Medical Products Inc., filed suit against Spinal Concepts alleging that Spinal Concepts' InCompass(R), Pathfinder(TM) and Speedlink(TM) products infringe U.S. Patent Nos. 5,466,237, 5,474,555 and 5,624,442, all of which are owned by Cross Medical. On July 14, 2004, the Company's

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subsidiary, EBI, also filed suit against Spinal Concepts alleging that an instrument sold with Spinal Concepts' AcuFix(TM) cervical plate infringes U.S. Patent No. 6,599,290 owned by EBI. On December 23, 2004, the Company and Spinal Concepts executed a global Settlement Agreement amicably resolving all three lawsuits between the Companies. The essential terms of the settlement include an exchange of paid-up cross licenses to all patents at issue, an exchange of covenants not to sue on any products that were at issue, and a payment of \$1 million to Spinal Concepts. Stipulations of dismissal are in the process of being filed and management considers this matter concluded.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FINANCIAL CONDITION AS OF November 30, 2004

The Company's cash and investments decreased \$61,307,000 to \$174,305,000 at November 30, 2004. This decrease resulted from the \$50,872,000 dividend paid during the first quarter, the \$103,990,000 used to purchase shares during the first six months pursuant to the Company's share repurchase programs and the acquisition of Interpore during the first quarter, offset by positive cash flow from operations and an increase in short term borrowings.

Cash flows provided by operating activities were \$179,183,000 for the first six months of fiscal 2005 compared to \$149,315,000 in 2004. The primary sources of fiscal year 2005 cash flows from operating activities were net income, depreciation and the write-off of in-process research and development at the acquisition date of Interpore. The primary use was an increase in inventory. Inventories increased from new product introductions, specifically new knee systems introduced in the US and Europe. Accounts and notes receivable and inventory balances were increased during the six month period by \$5.7 million and \$12.8 million, respectively, due to currency exchange rates.

Cash flows used in investing activities were \$310,463,000 for the first six months of fiscal 2005 compared to \$34,752,000 in 2004. The primary use of cash flows from investing activities were the acquisition of Interpore and capital expenditures. (see Footnote 2 in the Notes to Consolidated Financial Statements)

Cash flows from financing activities were \$67,289,000 for the first six months of fiscal 2005 compared to a use of \$97,107,000 in 2004. The primary source of cash flows from financing activities was the 36 month revolving credit facility in the amount of \$200 million used for the Interpore acquisition. The primary uses were the cash dividend paid and the share repurchase programs. In July 2004, the Company's Board of Directors declared a cash dividend of twenty cents (\$0.20) per share payable to shareholders of record at the close of business on July 16, 2004.

Currently available funds, together with anticipated cash flows generated from future operations are believed to be adequate to cover the Company's anticipated cash requirements, including capital expenditures, research and development costs and share repurchases.

RESULTS OF OPERATIONS FOR THE SIX MONTHS ENDED NOVEMBER 30, 2004 AS COMPARED TO THE SIX MONTHS ENDED NOVEMBER 30, 2003

Net sales increased 18% to \$894,834,000 for the six months ended November 30, 2004, from \$757,880,000 for the same period last year. This sales growth includes a positive impact from foreign currency of \$16.6 million and additional sales from the acquisition of Interpore of \$27.4 million, leaving net sales growth for the six months in local currencies at 12%. The Company's U.S.-based revenue increased 17% to \$605,310,000 during the first six months of fiscal 2005, while foreign sales increased 20% to \$289,524,000. The Interpore

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acquisition added \$21.8 million to U.S.-based revenue and \$5.6 million to foreign revenue. The Company's worldwide sales of reconstructive products during the first six months of fiscal 2005 were \$583,867,000, representing a 20% increase compared to the first six months of last year. Sales of fixation products were \$123,041,000 for the first six months fiscal 2005, representing a 1% increase as compared to the same period in 2004. Sales of spinal products were \$106,141,000 for the first six months of fiscal 2005, representing a 38% increase as compared to the same period in 2004. The increase was primarily a result of the Interpore acquisition and strong growth in EBI's spinal implants and orthobiological products. Fixation and spinal product sales have been negatively impacted by the combination of the Interpore and EBI sales forces, and at the same time the integration of Biomet's internal fixation sales force into EBI's fixation sales force. The Company expects this negative impact to continue during the next quarter. The Company's sales of other products totaled \$81,785,000, representing a 12% increase over the first six months of fiscal year 2004.

Cost of sales increased as a percentage of net sales to 28.7% for the first six months of fiscal 2005 from 28.3% for the same period last year. The current period impact of inventory step-up relating to acquisitions was 1.6%. This 1.6% increase was offset by a decrease of 1.2% in the percentage primarily as result of higher growth rates in domestic sales, where gross margins are higher, versus foreign sales. Selling, general and administrative expenses, as a percentage of net sales, increased to 36.5% compared to 35.5% for the first six months last year. This increase is a result of Interpore's traditionally higher selling, general and administrative expenses (0.3%), increased bad debt expense for EBI's domestic insurance receivables (0.4%) and continued expansion and consolidation of EBI's direct sales force. Research and development expenditures increased 25% during the first six months to \$38,082,000 reflecting the Company's continued emphasis on new product introductions and Interpore's traditionally higher expenditures on research and development (7%). In-process research and development expense relates to the acquired in-process research and development related to the Interpore acquisition, which was written off at the acquisition date. Operating income increased 1% from \$243,853,000 for the first six months of fiscal 2004, to \$246,880,000 for the first six months of fiscal 2005. The affect on operating income for the previously discussed acquisition related expenses was a reduction of \$40,424,000. Other income decreased from \$6,690,000 last year to \$(484,000) this year. Other income has been negatively impacted by a reduction in cash available for investments and an increase in short term debt, due to acquisitions. In addition, over the last twelve quarters, the Company has used \$705,897,000 to purchase its common stock. The effective income tax rate increased to 38.5% for the first six months of fiscal year 2005 from 34.8% last year primarily as a result of write-off of in-process research and development not being tax affected.

These factors resulted in a 5% decrease in net income from \$159,170,000 to \$151,632,000, a 3% decrease in basic earnings per share from \$0.62 to \$0.60 and a 5% decrease in diluted earnings per share from \$0.62 to \$0.59 for the periods presented. The affect of acquisition related expenses as discussed in the preceding paragraph, net of tax, on net income, basic earnings per share and diluted earnings per share was to decrease them by \$35,421,000, \$0.14 per share and \$0.14 per share, respectively.

RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED NOVEMBER 30, 2004
AS COMPARED TO THE THREE MONTHS ENDED NOVEMBER 30, 2003

Net sales increased 18% to \$456,674,000 for the second quarter ended November 30, 2004, from \$387,561,000 for the same period last year. This sales growth includes a positive impact from foreign currency of \$9.6 million and additional sales from the acquisition of Interpore of \$13.7 million, leaving net sales growth for the quarter in local currencies at 12%. The Company's U.S.-based

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revenue increased 17% to \$309,006,000 during the second quarter of fiscal 2005, while foreign sales increased 20% to \$147,668,000. The Interpore acquisition added \$10.4 million to U.S.-based revenue and \$3.3 million to foreign revenue. The Company's worldwide sales of reconstructive products during the second quarter of fiscal 2005 were \$301,385,000, representing a 20% increase compared to the second quarter of last year. Sales of fixation products were \$60,328,000 for the second quarter fiscal 2005, representing a slight increase as compared to the same period in 2004. Sales of spinal products were \$53,232,000 for the second quarter of fiscal 2005, representing a 37% increase as compared to the same period in 2004. The increase was primarily a result of the Interpore acquisition and strong growth in EBI's spinal implants and orthobiological products. Fixation and spinal product sales have been negatively impacted by the combination of the Interpore and EBI sales forces, and at the same time the integration of Biomet's internal fixation sales force into EBI's fixation sales force. The Company expects this negative impact to continue during the next quarter. The Company's sales of other products totaled \$41,729,000, representing a 15% increase over the second quarter of fiscal year 2004.

Cost of sales increased as a percentage of net sales to 28.7% for the second quarter of fiscal 2005 from 28.1% for the same period last year. The current period impact of inventory step-up relating to acquisitions was 1.6%. This 1.6% increase was offset by a decrease of 1% in the percentage primarily as a result of higher growth rates in domestic sales, where gross margins are higher, versus foreign sales. Selling, general and administrative expenses, as a percentage of net sales, increased to 36.4% compared to 35.3% for the second quarter last year. This increase is a result of Interpore's traditionally higher selling, general and administrative expenses (0.2%), increased bad debt expense for EBI's domestic insurance receivables (0.8%) and continued expansion and consolidation of EBI's direct sales force. Research and development expenditures increased 24% during the second quarter to \$19,606,000 reflecting the Company's continued emphasis on new product introductions and Interpore's traditionally higher expenditures on research and development (7%). Operating income increased 11% from \$126,297,000 for the second quarter of fiscal 2004, to \$139,648,000 for the second quarter of fiscal 2005. The affect on operating income for the previously discussed acquisition related expenses was a reduction of \$7,402,000. Other income decreased from \$3,669,000 last year to \$244,000 this year. Other income has been negatively impacted by a reduction in cash available for investments and an increase in short term debt, due to acquisitions and common stock repurchases. The effective income tax rate remained relatively flat at 34.8%.

These factors resulted in a 10% increase in net income to \$91,199,000 for the second quarter of fiscal 2005 as compared to \$82,692,000 for the same period in fiscal 2004, while basic and diluted earnings per share increased 13%, from \$0.32 to \$0.36 for the periods presented. The affect of acquisition related expenses as discussed in the preceding paragraph, net of tax, on net income, basic earnings per share and diluted earnings per share was to decrease them by \$4,831,000, \$0.02 per share and \$0.02 per share, respectively.

Item 3. Quantitative and Qualitative Disclosures about Market Risks.

There have been no material changes from the information provided in the Company's Annual Report on Form 10-K for the year ended May 31, 2004.

Item 4. Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures. As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of its management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures (as defined

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in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934). Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective in timely notification to them of information the Company is required to disclose in its periodic SEC filings and in ensuring that this information is recorded, processed summarized and reported within the time periods specified in the SEC's rules and regulations.

(b) Changes in Internal Control. During the second quarter of fiscal 2005 covered by this report, there have been no significant changes in internal control over financial reporting that have materially affected, or were reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1: Legal Proceedings.

On October 3, 2002, a complaint was filed against the Company by Spinal Concepts, Inc. ("Spinal Concepts") alleging that certain U.S. Patents owned by Spinal Concepts are infringed by the VueLock(R) Anterior Cervical Plate System manufactured by EBI, L.P. ("EBI"). On June 28, 2004, the Company's subsidiary, Cross Medical Products Inc., filed suit against Spinal Concepts alleging that Spinal Concepts' InCompass(R), Pathfinder(TM) and Speedlink(TM) products infringe U.S. Patent Nos. 5,466,237, 5,474,555 and 5,624,442, all of which are owned by Cross Medical. On July 14, 2004, the Company's subsidiary, EBI, also filed suit against Spinal Concepts alleging that an instrument sold with Spinal Concepts' AcuFix(TM) cervical plate infringes U.S. Patent No. 6,599,290 owned by EBI. On December 23, 2004, the Company and Spinal Concepts executed a global Settlement Agreement amicably resolving all three lawsuits between the Companies. The essential terms of the settlement include an exchange of paid-up cross licenses to all patents at issue, an exchange of covenants not to sue on any products that were at issue, and a payment of \$1 million to Spinal Concepts. Stipulations of dismissal are in the process of being filed and management considers this matter concluded.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

As of November 30, 2004, the Company had two publicly-announced share repurchase programs outstanding. The first, announced July 1, 2004, approved the purchase of 2,500,000 shares to be automatically purchased in equal installments over a twelve-month period expiring July 1, 2005. The second, also announced July 1, 2004, approved the purchase of shares up to \$100 million in open market or privately negotiated transactions. Information on shares repurchased in the most recently completed quarter is as follows:

Period	Total Number of shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum Number of Shares (or Approximate Dollar Value) that May Yet be Purchased Under the Plans
September 1-30	252,000	\$47.14	252,000	1,756,000 shares and \$64,414,746
October 1-31	331,000	45.60	331,000	1,504,000 shares and \$60,945,118
November 1-30	252,000	47.75	252,000	1,252,000 shares and \$60,945,118
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- (11) No exhibit
- (15) No exhibit.
- (18) No exhibit.
- (19) No exhibit.
- (22) No exhibit.
- (23) No exhibit.
- (24) No exhibit.
- (31) 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- (32) 32.1 Written Statement of Chief Executive Officer and Chief Financial Officer Pursuant to Sections 906 of the Sarbanes-Oxley Act of 2002.