CHIRON CORP
Form 10-Q
August 08, 2001

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended June 30, 2001

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: 0-12798

CHIRON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**94-2754624**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4560 Horton Street, Emeryville, California	**94608**
(Address of principal executive offices)	(Zip code)

(510) 655-8730

(Registrant's telephone number, including area code)

Not Applicable

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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 the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Title of Class	Outstanding at July 31, 2001
Common Stock, $0.01 par value	189,877,772

CHIRON CORPORATION
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Item 1. Financial Statements

CHIRON CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(In thousands, except share data)

	June 30, 2001	December 31, 2000
ASSETS		
Current assets:		
Cash and cash equivalents	$ 294,705	$ 166,990
Short-term investments in marketable debt securities	381,099	534,621
Total cash and short-term investments	675,804	701,611
Accounts receivable, net	253,824	218,946
Current portion of notes receivable	5,679	6,179
Inventories	121,187	108,713
Current net deferred income tax asset	41,525	35,980
Derivative financial instruments	1,728	
Other current assets	41,030	31,129
Total current assets	1,140,777	1,102,558
Noncurrent investments in marketable debt securities	544,260	149,925
Property, plant, equipment and leasehold improvements, at cost:		
Land and buildings	137,658	138,981
Laboratory, production and office equipment	343,340	345,495
Leasehold improvements	85,384	87,899
Construction-in-progress	32,215	24,926
	598,597	597,301
Less accumulated depreciation and amortization	(297,688)	(284,098)
Property, plant, equipment and leasehold improvements, net	300,909	313,203
Purchased technologies, net	291,507	302,134
Goodwill, net	228,330	240,647
Other intangible assets, net	161,946	163,759
Investments in equity securities and affiliated companies	152,263	155,794
Noncurrent notes receivable	13,289	12,999
Other noncurrent assets	19,737	17,057
	$ 2,853,018	$ 2,458,076
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 46,571	$ 48,492
Accrued compensation and related expenses	40,513	44,972
Short-term borrowings	1,054	1,171
Current portion of long-term debt	547	1,212
Current portion of unearned revenue	41,080	48,273
Taxes payable	74,550	130,862
Derivative financial instruments	4,239	
Other current liabilities	138,604	138,874
Total current liabilities	347,158	413,856
Long-term debt	404,978	3,039
Noncurrent net deferred income tax liability	78,126	74,921
Noncurrent unearned revenue	79,104	41,677
Other noncurrent liabilities	40,901	40,476
Minority interest	3,544	3,025

	June 30, 2001	December 31, 2000
Total liabilities	953,811	576,994
Commitments and contingencies (Note 10)		
Put options	20,134	
Stockholders' equity:		
Common stock	1,917	1,917
Additional paid-in capital	2,418,857	2,418,032
Deferred stock compensation	(18,786)	(22,986)
Accumulated deficit	(397,464)	(438,967)
Accumulated other comprehensive income (loss)	(34,540)	17,497
Treasury stock, at cost (1,939,000 shares at June 30, 2001 and 2,183,000 shares at December 31, 2000)	(90,911)	(94,411)
Total stockholders' equity	1,879,073	1,881,082
	$ 2,853,018	$ 2,458,076

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of this statement.

CHIRON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Revenues:				
Product sales, net	$ 173,666	$ 161,021	$ 342,506	$ 318,627
Equity in earnings of unconsolidated joint businesses	22,256	22,404	37,881	38,122
Collaborative agreement revenues	11,970	7,301	21,031	14,095
Royalty and license fee revenues	40,969	36,962	103,145	67,951
Other revenues	12,340	13,167	16,229	18,805
Total revenues	261,201	240,855	520,792	457,600
Operating expenses:				
Cost of sales	63,629	48,279	118,559	99,530
Research and development	84,645	71,178	169,377	142,168
Selling, general and administrative	60,882	46,286	119,685	97,197

	Three Months Ended June 30,		Six Months Ended June 30,	
Amortization expense	11,338	2,049	22,885	4,173
Restructuring and reorganization charge reversals (Note 5)		(76)		(447)
Other operating expenses	6,093	4,127	8,276	6,825
Total operating expenses	226,587	171,843	438,782	349,446
Income from operations	34,614	69,012	82,010	108,154
Gain (loss) on sale of assets			2,426	(224)
Interest expense	(865)	(4,333)	(1,263)	(9,359)
Other income, net	14,171	18,610	32,227	43,080
Minority interest	(323)	(200)	(542)	(401)
Income from continuing operations before income taxes	47,597	83,089	114,858	141,250
Provision for income taxes	13,653	25,677	36,171	43,754
Income from continuing operations	33,944	57,412	78,687	97,496
Gain on disposal of discontinued operations (Note 3)	3,653	2,190	3,653	2,342
Net income	$ 37,597	$ 59,602	$ 82,340	$ 99,838
Basic earnings per share (Note 2):				
Income from continuing operations	$ 0.18	$ 0.32	$ 0.41	$ 0.54
Net income	$ 0.20	$ 0.33	$ 0.43	$ 0.55
Diluted earnings per share (Note 2):				
Income from continuing operations	$ 0.17	$ 0.30	$ 0.40	$ 0.51
Net income	$ 0.19	$ 0.31	$ 0.42	$ 0.52

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of this statement.

CHIRON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2001	2000	2001	2000
Net income	$ 37,597	$ 59,602	$ 82,340	$ 99,838
Other comprehensive income (loss):				
Change in foreign currency translation adjustment during the period, net of tax benefit of $293 and $534 for the three months ended June 30, 2001 and 2000, respectively, and $545 and $634 for the six months ended June 30, 2001 and 2000, respectively	(14,341)	295	(43,604)	(9,887)
Unrealized derivative gains from cash flow hedges:				
Net unrealized derivative gains from cash flow hedges arising during the period, net of tax provision of $240 and $417 for the three and six months ended June 30, 2001, respectively	579		895	
Reclassification adjustment for net gains included in net income, net of tax provision of $147 for each of the three and six months ended June 30, 2001	(234)		(234)	
Net unrealized derivative gains from cash flow hedges	345		661	
Unrealized gains (losses) from investments:				
Net unrealized holding gains (losses) arising during the period, net of tax (provision) benefit of $(8,591) and $(8,661) for the three months ended June 30, 2001 and 2000, respectively, and $3,401 and $(22,266) for the six months ended June 30, 2001 and 2000, respectively	6,479	14,132	(4,893)	36,330
Reclassification adjustment for net gains included in net income, net of tax provision of $2,394 and $60 for the three months ended June 30, 2001 and 2000, respectively, and $2,651 and $60 for the six months ended June 30, 2001 and 2000, respectively	(3,744)	(98)	(4,201)	(98)
Net unrealized gains (losses) from investments	2,735	14,034	(9,094)	36,232
Other comprehensive income (loss)	(11,261)	14,329	(52,037)	26,345
Comprehensive income	$ 26,336	$ 73,931	$ 30,303	$ 126,183

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of this statement.

CHIRON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	Six Months Ended June 30,	
	2001	2000
Net cash provided by operating activities	$ 15,316	$ 137,168
Cash flows from investing activities:		
Purchases of investments in marketable debt securities	(666,098)	(2,470,807)
Proceeds from sale and maturity of investments in marketable debt securities	424,527	2,703,640
Capital expenditures	(25,829)	(21,983)
Proceeds from sale of assets	8,186	1,000
Purchases of equity securities and interests in affiliated companies	(11,144)	(8,750)
Proceeds from sale of equity securities and interests in affiliated companies	7,596	3,098
Cash paid to purchase PathoGenesis Corporation	(5,631)	
Other, net	2,811	595
Net cash (used in) provided by investing activities	(265,582)	206,793
Cash flows from financing activities:		
Net repayment of short-term borrowings	(117)	(22,413)
Repayment of debt and capital leases	(555)	(69,430)
Payments to acquire treasury stock	(63,118)	(192,343)
Proceeds from reissuance of treasury stock	35,774	49,890
Proceeds from issuance of common stock		920
Proceeds from issuance of Liquid Yield Option Notes	401,829	
Proceeds from put options	4,168	
Net cash provided by (used in) financing activities	377,981	(233,376)
Net increase in cash and cash equivalents	127,715	110,585
Cash and cash equivalents at beginning of the period	166,990	363,865
Cash and cash equivalents at end of the period	$ 294,705	$ 474,450

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of this statement.

CHIRON CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2001

(Unaudited)

Note 1 The Company and Summary of Significant Accounting Policies

Basis of Presentation

The information presented in the Condensed Consolidated Financial Statements at June 30, 2001, and for the three and six months ended June 30, 2001 and 2000, is unaudited but includes all normal recurring adjustments, which the management of Chiron Corporation ("Chiron" or the "Company") believes to be necessary for fair presentation of the periods presented.

The Condensed Consolidated Balance Sheet amounts at December 31, 2000 have been derived from audited financial statements. Interim results are not necessarily indicative of results for a full year. This information should be read in conjunction with Chiron's audited Consolidated Financial Statements for the year ended December 31, 2000, which are included in the Annual Report on Form 10-K filed by the Company with the Securities and Exchange Commission.

Principles of Consolidation

The Condensed Consolidated Financial Statements include the accounts of the Company and its majority-owned subsidiaries. For consolidated majority-owned subsidiaries in which the Company owns less than 100%, the Company records "Minority interest" in the Condensed Consolidated Financial Statements to account for the ownership interest of the minority owner. Investments in joint ventures, partnerships and interests in which the Company has an equity interest of 50% or less are accounted for using either the equity or cost method. All significant intercompany accounts and transactions have been eliminated in consolidation.

On September 21, 2000, Chiron acquired PathoGenesis Corporation ("PathoGenesis"). The Company included PathoGenesis' operating results, including the seven business days from September 21 to 30, 2000, in its consolidated operating results beginning on October 1, 2000. PathoGenesis' operating results for the seven business days in September 2000 were not significant to the Company's consolidated operating results (see Note 4).

In 2001, the Company became a limited partner of Forward Venture IV, L.P. The Company will pay $15.0 million over ten years, of which $4.3 million was paid through June 30, 2001, for a 6.35% ownership percentage. In 2000, the Company became a limited partner of Burrill Biotechnology Capital Fund, L.P. The Company will pay $25.0 million over five years, of which $10.8 million was paid through June 30, 2001, for a 23.19% ownership percentage. The Company accounts for both investments under the equity method of accounting pursuant to EITF Topic No. D-46 "Accounting for Limited Partnership Investments."

Use of Estimates and Reclassifications

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the Company's consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates.

The Company, prior to filing its financial statements on Form 10-Q, publicly releases an unaudited condensed balance sheet and statement of operations. Between the date of the Company's earnings release and the filing of its Form 10-Q, reclassifications may be required. These reclassifications, when made, have no effect on income from continuing operations, net income or earnings per share.

Certain previously reported amounts have been reclassified to conform with the current period presentation.

Related to the acquisition of PathoGenesis on September 21, 2000, the Company allocated the purchase price based on the estimated fair values of the assets acquired and liabilities assumed. Through June 30, 2001, the Company recorded a purchase price adjustment resulting from (i) a final reconciliation of PathoGenesis registered shares of common stock, (ii) the true-up of severance, employee relocation, leasing and legal costs to amounts actually paid and (iii) the related deferred tax effects, the total of which resulted in a $1.3 million increase to the purchase price and a $0.1 million increase to goodwill. For the six months ended June 30, 2001, this adjustment had no material impact on amortization expense or earnings per share.

In the third quarter of 2000, the Company reclassified $32.7 million from "Accumulated other comprehensive income (loss)," of which $34.9 million was reclassified to the "Noncurrent net deferred income tax liability" with an offsetting entry of $2.2 million to "Taxes payable." These reclassifications represented the cumulative tax effect on the Company's net unrealized gains from investments and the Company's foreign currency translation adjustments, respectively, as the Company had not previously recorded these amounts net of deferred taxes and taxes payable. The adjustment had no effect on income from continuing operations, net income or earnings per share. Certain previously reported amounts in the Condensed Consolidated Balance Sheets and the Condensed Consolidated Statements of Comprehensive Income have been reclassified to conform with the current period presentation.

In the second quarter of 2001, the Company reclassified $28.0 million and $32.1 million as of June 30, 2001 and December 31, 2000, respectively, from "Other intangible assets, net" to "Goodwill, net." The reclassification represented the goodwill, net of accumulated amortization, related to the Company's acquisition of a 49% interest and a 51% interest in Chiron Behring in 1996 and 1998, respectively.

Inventories

Inventories are stated at the lower of cost or market using the moving weighted-average cost method. Inventories consisted of the following (in thousands):

	June 30, 2001	December 31, 2000
Finished goods	$ 21,062	$ 25,590
Work-in-process	70,230	57,754
Raw materials	29,895	25,369
	$ 121,187	$ 108,713

Derivative Financial Instruments

Effective January 1, 2001, the Company implemented Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"), as amended by SFAS No. 138, which establishes accounting and reporting standards for derivatives and hedging activities. All derivatives are required to be recorded on the balance sheet at fair value. Changes in

the fair value of derivatives are accounted for depending upon the exposure being hedged and whether the derivatives qualify and are designated for hedge accounting.

The Company uses various derivatives, such as foreign currency option contracts ("currency options") and forward foreign currency contracts ("currency forwards"), to reduce foreign exchange risks. The Company also uses forward sales contracts ("equity forwards") to reduce equity securities risk. Derivatives are not used for trading or speculative purposes. The Company's control environment includes policies and procedures for risk assessment and the approval, reporting and monitoring of foreign currency hedging activities. Counterparties to the Company's hedging agreements are major financial institutions. These hedging agreements are generally not collateralized. The Company manages the risk of counterparty default on its derivatives through the use of credit standards, counterparty diversification and monitoring of counterparty financial conditions. Chiron has not experienced any losses due to counterparty default.

Foreign Currency Hedging

A significant portion of the Company's operations consists of manufacturing and sales activities in western European countries. As a result, the Company's financial results may be affected by changes in the foreign currency exchange rates of those related countries.

Chiron may selectively hedge anticipated currency exposures by purchasing currency options, which are designated as cash flow hedges under SFAS 133 and typically expire within twelve months. Changes in the fair value of currency options are recorded in "Other comprehensive income" and are recognized in earnings when the forecasted transaction occurs. When currency options expire, any amounts recorded in "Other comprehensive income" are reclassified to earnings.

The Company also uses currency forwards to hedge the gains and losses generated by the remeasurement of certain assets and liabilities denominated in nonfunctional currencies. These derivatives are not designated as hedges under SFAS 133. Changes in the fair value of currency forwards are recognized currently in earnings. Changes in the fair value of currency forwards are offset largely by changes upon remeasurement of the underlying assets and liabilities. Typically, these contracts have maturities of three months or less.

Equity Securities Hedging

The Company has exposure to equity price risk because of its investments in equity securities. Generally, the Company obtains these securities through its collaboration agreements with other pharmaceutical and biotechnology partners. Changes in share prices affect the value of Chiron's equity portfolio.

The Company selectively enters into equity forwards, which are designated as fair value hedges under SFAS 133 and typically expire within two to four years. At the inception of the hedge, the difference between the cost and the fair value of the equity investment remains in "Other comprehensive income." Subsequent changes in the fair value of the equity forwards and the underlying equity investment are recognized in earnings. When equity forwards mature and the underlying equity investment is sold, any amounts recorded in "Other comprehensive income" related to the underlying equity investment are reclassified to earnings.

For currency options and equity forwards, the Company assumes no ineffectiveness because the critical terms of the derivative instrument and of the underlying exposure are the same. The Company expects that changes in the fair value of the underlying exposure will be offset completely by changes in the fair value of the derivative instrument, both at inception and on an ongoing basis. The critical terms are reviewed quarterly. All time value changes are deemed ineffective and are recognized immediately in earnings.

Income Taxes

The effective tax rate for 2001 is estimated to be approximately 31.4% of pretax income from continuing operations, which reflects the amortization of goodwill and acquired identifiable intangible assets related to the PathoGenesis acquisition. The effective tax rate may be affected in future periods by changes in management's estimates with respect to the Company's deferred tax assets and other items affecting the overall tax rate. Income tax expense for the three and six months ended June 30, 2000 was based on an estimated annual effective tax rate on pretax income from continuing operations of approximately 31.0%.

The annual reported effective tax rate for 2000 was 84.4% of pretax income from continuing operations and reflected the write-off of purchased in-process technologies and amortization expense on goodwill and acquired identifiable intangible assets related to the PathoGenesis acquisition.

Put Options

Proceeds from sales of put options, which allow for net-cash, net-share or physical settlement, are recorded in stockholders' equity and an amount equal to the redemption price of the common stock is reclassified from permanent equity to temporary equity. If a put option is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the put option during the period it was classified as equity is recorded in stockholders' equity. The Company reassesses the classification of its put options on a quarterly basis. If a put option is settled in net cash or net shares, the amount reported in temporary equity is transferred and reported as an addition to permanent equity.

In January 2001, the Company initiated a put option program. Under this program, the Company entered into a contract with a third party to sell put options on Chiron stock, entitling the holder to sell to the Company 0.5 million shares at $44.95 per share on April 19, 2001. In connection with the sale, the Company collected a $2.6 million premium, which was recorded in "Additional paid-in capital" in the Condensed Consolidated Balance Sheets. The amount of the Company's obligation to repurchase such shares upon exercise of the outstanding put options, totaling $22.5 million, was reclassified from "Additional paid-in capital" to "Put options" in temporary equity in the Company's Condensed Consolidated Balance Sheets at March 31, 2001. On April 19, 2001, Chiron's closing stock price was $47.02. Since the closing stock price was above the stipulated $44.95, the third party elected not to exercise the options. As a result, the temporary equity of $22.5 million was reclassified to permanent equity in the second quarter of 2001.

In June 2001, the Company entered into another contract with a third party to sell put options on Chiron stock, entitling the holder to sell to the Company 0.4 million shares at $50.34 per share on September 19, 2001. In connection with the sale, the Company collected a $1.5 million premium, which was recorded in "Additional paid-in capital" in the Condensed Consolidated Balance Sheets. The amount of

the Company's obligation to repurchase such shares upon exercise of the outstanding put options, totaling $20.1 million, was reclassified from "Additional paid-in capital" to "Put options" in temporary equity in the Company's Condensed Consolidated Balance Sheets at June 30, 2001.

Treasury Stock

Treasury stock is stated at cost. Gains on reissuance of treasury stock are credited to "Additional paid-in capital." Losses on reissuance of treasury stock are charged to "Additional paid-in capital" to the extent of available net gains on reissuance of treasury stock. Otherwise, losses are charged to "Accumulated deficit." The Company charged losses of $25.1 million and $40.8 million for the three and six months ended

June 30, 2001, respectively, and $39.5 million and $88.5 million for the three and six months ended June 30, 2000, respectively, to "Accumulated deficit" in the Condensed Consolidated Balance Sheets.

Note 2 Earnings Per Share

Basic earnings per share is based upon the weighted-average number of common shares outstanding. Diluted earnings per share is based upon the weighted-average number of common shares and dilutive potential common shares outstanding. Dilutive potential common shares could result from (i) the assumed exercise of outstanding stock options, warrants and equivalents, which are included under the treasury-stock method; (ii) performance units to the extent that dilutive shares are assumed issuable; (iii) the assumed exercise of outstanding put options, which are included under the reverse treasury-stock method; and (iv) convertible notes and debentures, which are included under the if-converted method. Due to rounding, quarterly amounts may not sum fully to yearly amounts.

The following table sets forth the computations for basic and diluted earnings per share on income from continuing operations (in thousands, except per share data):

	Three Months Ended June 30,	Six Months Ended June 30,
&n		