CHIRON CORP
Form 10-Q
August 09, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended June 30, 2002
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: 0-12798

CHIRON CORPORATION

(Exact name of registrant as specified in its charter)

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

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, 2002
Common Stock, $0.01 par value	188,981,912

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Item 1. Financial Statements

CHIRON CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands, except share data)

	June 30, 2002	December 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 268,328	$ 320,673
Short-term investments in marketable debt securities	575,608	456,506
Total cash and short-term investments	843,936	777,179
Accounts receivable, net	249,711	223,358
Current portion of notes receivable	6,317	5,103
Inventories	140,935	111,357
Current net deferred income tax asset	41,683	33,717
Derivative financial instruments	13,663	756
Other current assets	46,285	30,677

	June 30, 2002	December 31, 2001
Total current assets	1,342,530	1,182,147
Noncurrent investments in marketable debt securities	406,933	524,858
Property, plant, equipment and leasehold improvements, at cost:		
Land and buildings	149,774	144,789
Laboratory, production and office equipment	395,806	361,423
Leasehold improvements	91,932	89,392
Construction-in-progress	57,889	26,341
	695,401	621,945
Less accumulated depreciation and amortization	(347,449)	(308,557)
Property, plant, equipment and leasehold improvements, net	347,952	313,388
Purchased technologies, net	267,914	279,298
Goodwill	236,006	224,742
Other intangible assets, net	145,618	155,086
Investments in equity securities and affiliated companies	88,638	146,984
Noncurrent notes receivable	8,609	9,706
Noncurrent derivative financial instruments	17,407	
Other noncurrent assets	30,385	30,700
	$ 2,891,992	$ 2,866,909
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 59,327	$ 56,773
Accrued compensation and related expenses	39,586	47,020
Derivative financial instruments		2,861
Short-term borrowings	292	526
Current portion of unearned revenue	21,477	22,328
Income taxes payable	85,841	83,099
Other current liabilities	120,263	111,766
Total current liabilities	326,786	324,373
Long-term debt	412,816	408,696
Noncurrent derivative financial instruments	259	7,646
Noncurrent net deferred income tax liability	32,234	58,944
Noncurrent unearned revenue	67,699	74,371
Other noncurrent liabilities	47,480	42,873
Minority interest	4,731	3,894
Total liabilities	892,005	920,797
Commitments and contingencies (Note 8)		
Put options	11,361	13,764
Stockholders' equity:		
Common stock	1,917	1,917
Additional paid-in capital	2,448,857	2,441,281
Deferred stock compensation	(15,671)	(17,506)
Accumulated deficit	(352,350)	(360,997)
Accumulated other comprehensive income (loss)	22,522	(21,286)
	(116,649)	(111,061)

	June 30, 2002	December 31, 2001
Treasury stock, at cost (2,714,000 shares at June 30, 2002 and 2,341,000 shares at December 31, 2001)		
Total stockholders' equity	1,988,626	1,932,348
	$ 2,891,992	$ 2,866,909

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

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CHIRON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	**2001**	**2002**	**2001**
Revenues:				
Product sales, net	$ 211,293	$ 173,666	$ 384,877	$ 342,506
Equity in earnings of unconsolidated joint businesses	27,394	22,256	46,192	37,881
Collaborative agreement revenues	6,602	11,970	12,809	21,031
Royalty and license fee revenues	45,494	40,969	90,372	103,145
Other revenues	8,495	12,340	17,225	16,229
Total revenues	299,278	261,201	551,475	520,792
Operating expenses:				
Cost of sales	76,225	63,629	142,391	118,559
Research and development	83,530	84,645	162,303	169,377
Selling, general and administrative	71,093	60,882	133,863	119,685
Amortization expense	7,446	11,338	14,824	22,885
Write-off of purchased in-process technologies			54,781	
Other operating expenses	899	6,093	5,482	8,276
Total operating expenses	239,193	226,587	513,644	438,782
Income from operations	60,085	34,614	37,831	82,010
Gain on sale of assets				2,426
Interest expense	(3,133)	(865)	(6,288)	(1,263)
Other income, net	12,613	14,171	32,760	32,227
Minority interest	(464)	(323)	(883)	(542)
Income from continuing operations before income taxes	69,101	47,597	63,420	114,858

	Three Months Ended June 30,		Six Months Ended June 30,	
Provision for income taxes	18,657	13,653	31,913	36,171
Income from continuing operations	50,444	33,944	31,507	78,687
Gain on disposal of discontinued operations (Note 3)		3,653		3,653
Net income	$ 50,444	$ 37,597	$ 31,507	$ 82,340
Basic earnings per share (Note 2):				
Income from continuing operations	$ 0.27	$ 0.18	$ 0.17	$ 0.41
Net income	$ 0.27	$ 0.20	$ 0.17	$ 0.43
Diluted earnings per share (Note 2):				
Income from continuing operations	$ 0.26	$ 0.17	$ 0.16	$ 0.40
Net income	$ 0.26	$ 0.19	$ 0.16	$ 0.42

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

CHIRON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)
(In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	**2001**	**2002**	**2001**
Net income	$ 50,444	$ 37,597	$ 31,507	$ 82,340
Other comprehensive income (loss):				
Change in foreign currency translation adjustment during the period, net of tax (provision) benefit of $(7,294) and $293 for the three months ended June 30, 2002 and 2001, respectively, and $(6,449) and $545 for the six months ended June 30, 2002 and 2001, respectively	61,668	(14,341)	55,233	(43,604)
Unrealized derivative gains (losses) from cash flow hedges:				
Net unrealized derivative gains (losses) from cash flow hedges arising during the period, net of tax (benefit) provision of $(72) and $240 for the three months ended June 30, 2002 and 2001, respectively, and $417 for the six months ended June 30, 2001	(118)	579		895
Reclassification adjustment for net gains included in net income, net of tax provision of $147 for the three and six months ended June 30, 2001		(234)		(234)

	Three Months Ended June 30,		Six Months Ended June 30,	
Net unrealized derivative gains (losses) from cash flow hedges	(118)	345		661
Unrealized gains (losses) from investments:				
Net unrealized holding gains (losses) arising during the period, net of tax (provision) benefit of $651 and $(8,591) for the three months ended June 30, 2002 and 2001, respectively, and $3,532 and $3,401 for the six months ended June 30, 2002 and 2001, respectively	658	6,479	(5,623)	(4,893)
Reclassification adjustment for net gains included in net income, net of tax provision of $1,891 and $2,394 for the three months ended June 30, 2002 and 2001, respectively, and $3,587 and $2,651 for the six months ended June 30, 2002 and 2001, respectively	(3,065)	(3,744)	(5,802)	(4,201)
Net unrealized gains (losses) from investments	(2,407)	2,735	(11,425)	(9,094)
Other comprehensive income (loss)	59,143	(11,261)	43,808	(52,037)
Comprehensive income	$ 109,587	$ 26,336	$ 75,315	$ 30,303

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

CHIRON CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Six Months Ended June 30,	
	2002	**2001**
Net cash provided by operating activities	$ 82,566	$ 15,316
Cash flows from investing activities:		
Purchases of investments in marketable debt securities	(320,675)	(666,098)
Proceeds from sale and maturity of investments in marketable debt securities	311,113	424,527
Capital expenditures	(54,323)	(25,829)
Proceeds from sales of assets	182	8,186
Purchases of equity securities and interests in affiliated companies	(3,093)	(11,144)
Proceeds from sale of equity securities and interests in affiliated companies	13,415	7,596
Cash paid to purchase businesses, net of cash acquired	(55,284)	(5,631)
Other, net	(877)	2,811
Net cash used in investing activities	(109,542)	(265,582)

	Six Months Ended June 30,	
Cash flows from financing activities:		
Net repayment of short-term borrowings	(308)	(117)
Repayment of debt and capital leases		(555)
Payments to acquire treasury stock	(45,116)	(63,118)
Proceeds from reissuance of treasury stock	18,027	35,774
Proceeds from issuance of Liquid Yield Option Notes		401,829
Proceeds from put options	2,028	4,168
Net cash (used in) provided by financing activities	(25,369)	377,981
Net (decrease) increase in cash and cash equivalents	(52,345)	127,715
Cash and cash equivalents at beginning of the period	320,673	166,990
Cash and cash equivalents at end of the period	$ 268,328	$ 294,705

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

CHIRON CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2002

(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, 2002, and for the three and six months ended June 30, 2002 and 2001, is unaudited but includes all normal recurring adjustments, which Chiron Corporation believes to be necessary for fair presentation of the periods presented.

The condensed consolidated balance sheet amounts at December 31, 2001 have been derived from audited financial statements. Historically, Chiron's operating results have varied considerably from period to period due to the nature of Chiron's collaborative, royalty and license arrangements and the seasonality of certain vaccine products. In addition, the mix of products sold and the introduction of new products will affect comparability from quarter to quarter. As a consequence, Chiron's interim results in any one quarter are not necessarily indicative of results to be expected for a full year. This information should be read in conjunction with Chiron's audited consolidated financial statements for the year ended December 31, 2001, which are included in the Annual Report on Form 10-K filed by Chiron with the Securities and Exchange Commission.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of Chiron and its majority-owned subsidiaries. For consolidated majority-owned subsidiaries in which Chiron owns less than 100%, Chiron records minority interest in the condensed consolidated financial statements to account for the ownership interest of the minority owner. Investments in joint ventures, limited partnerships and interests in which Chiron 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 February 20, 2002, Chiron acquired Matrix Pharmaceutical, Inc., a company that was developing tezacitabine, a drug to treat cancer. Chiron acquired all of the outstanding shares of common stock of Matrix Pharmaceutical at $2.21 per share, which, including estimated acquisition costs, resulted in a total purchase price of approximately $67.1 million. Chiron accounted for the acquisition as an asset purchase and included Matrix Pharmaceutical's operating results, including the seven business days in February 2002, in its consolidated operating results beginning on March 1, 2002. Matrix Pharmaceutical is part of Chiron's biopharmaceuticals segment.

In 2001, Chiron became a limited partner of Forward Venture IV, L.P. Chiron will pay $15.0 million over ten years, of which $6.6 million was paid through June 30, 2002, for a 6.35% ownership percentage. In 2000, Chiron became a limited partner of Burrill Biotechnology Capital Fund, L.P. Chiron will pay $25.0 million over five years, of which $15.3 million was paid through June 30, 2002, for a 23.26% ownership percentage. Chiron accounts for both investments under the equity method of accounting pursuant to Emerging Issues Task Force Topic No. D-46 "Accounting for Limited Partnership Investments." In addition, in July 2002, Chiron agreed to invest up to $5.0 million in TPG Biotechnology Partners, L.P.

Use of Estimates and Reclassifications

The preparation of financial statements requires management to make estimates, assumptions and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, management evaluates its estimates, including those related to investments; inventories; derivatives; intangible assets; product discounts, rebates and returns; bad debts; collaborative, royalty and license arrangements; restructuring; pension and other post-retirement benefits; income taxes; and litigation and other contingencies. Chiron bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from those estimates under different assumptions or conditions.

Chiron recognizes a portion of revenue for product sales of Betaseron® upon shipment to its marketing partner, and the remainder based on a contractual percentage of sales by its marketing partner. Chiron also earns royalties on the marketing partner's European sales of Betaferon®. Prior to the first quarter 2002, Chiron had accounted for non-U.S. product sales on a one-quarter lag and royalties as a percentage of forecast received from its marketing partner, with an adjustment of the estimate to actual in the subsequent quarter. More current information of non-U.S. Betaseron® sales became available in 2002, and as a result, Chiron is able to recognize Betaseron® product sales and Betaferon® royalties on a current basis. The effect of this change on results, net of tax, was a decrease in net loss for the first quarter 2002 and an increase in net income for the six months ended June 30, 2002, by $3.1 million for product sales and $2.8 million for royalties ($0.03 per basic and diluted share).

Chiron, 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 Chiron'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 operations, net income or earnings per share.

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

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, 2002	December 31, 2001
Finished goods	$ 35,071	$ 26,683
Work-in-process	76,992	60,512
Raw materials	28,872	24,162
	$ 140,935	$ 111,357

Income Taxes

The reported effective tax rate for 2002 is 27.0% of pretax income from continuing operations, excluding the write-off of purchased in-process technologies related to the acquisition of Matrix Pharmaceutical, Inc. (see Note 4). The effective tax rate may be affected in future periods by changes in Chiron's estimates with respect to the deferred tax assets and other items affecting the overall tax rate. Income tax expense for the six months ended June 30, 2001 was based on an estimated annual effective tax rate on pretax income from continuing operations of approximately 31.4%.

Put Options

Chiron utilizes put options to facilitate the repurchase of common stock. The put option contracts provide that Chiron, at its option, can settle with physical delivery or net shares equal to the difference between the exercise price and the value of the option as determined by the contract. Accordingly, these contracts are initially measured at fair value and reported in stockholders' equity as additional paid-in-capital. Subsequent changes in fair value are not recognized. If these instruments are settled through the payment or receipt of cash, additional paid-in-capital is adjusted.

As of June 30, 2002, Chiron has an outstanding contract with a third party to sell put options on Chiron stock, entitling the holder to sell to Chiron 0.3 million shares. In connection with the sale, Chiron collected a $0.9 million premium. The option expired on August 6, 2002 and had an exercise price of $37.87 per share. The amount of Chiron's obligation to repurchase such shares upon exercise of the outstanding put options, totaling $11.4 million, was reclassified from "Additional paid-in capital" to "Put options" in temporary equity in the Condensed Consolidated Balance Sheet at June 30, 2002. On August 6, 2002, Chiron's closing stock price was $34.21. Since the closing stock price was below the stipulated $37.87, the third party elected to exercise the options. As a result, Chiron repurchased the shares in the third quarter 2002.

In July 2002, Chiron entered into another contract with a third party to sell put options on Chiron stock, entitling the holder to sell to Chiron 0.5 million shares. In connection with the sale, Chiron collected a $1.7 million premium. The option expires in October 2002 and has an exercise price of $32.05 per share. The amount of Chiron's obligation to repurchase such shares upon exercise of the outstanding put options, totaling $16.0 million, will be reclassified from "Additional paid-in capital" to "Put options" in temporary equity in the third quarter 2002.

As of December 31, 2001, Chiron had an outstanding contract with a third party to sell put options on Chiron stock, entitling the holder to sell to Chiron 0.3 million shares. The option expired on March 28, 2002 and had an exercise price of $45.88 per share. The amount of Chiron's obligation to repurchase such shares upon exercise of the outstanding put options, totaling $13.8 million, was reclassified from "Additional paid-in capital" to "Put options" in temporary equity in the Condensed Consolidated Balance Sheet at December 31, 2001. On March 28, 2002, Chiron's closing stock price was $45.89. Since the closing stock price was above the stipulated $45.88, the third party elected not to exercise the options. As a result, the temporary equity of $13.8 million was reclassified to permanent equity in the first quarter 2002.

Comprehensive Income

In the first and second quarters of 2001, the foreign currency translation component of comprehensive income included the tax effects of the non-permanently reinvested 2000 earnings in Chiron's German and Italian vaccines business in accordance with the investment and tax policy adopted in 2000. During the first and second quarters of 2001, the undistributed 2001 earnings in Chiron's German and Italian vaccines business were expected to be reinvested permanently and, as a result, no tax effect was provided on the foreign currency translation component of comprehensive income. Beginning in the third quarter 2001, tax effects of the decision not to permanently reinvest the 2001 earnings in Chiron's German and Italian vaccines business were recorded. For all other foreign jurisdictions, the undistributed earnings of Chiron's foreign investments are expected to be reinvested permanently.

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." Chiron charged losses of $5.4 million and $22.9 million for the three and six months ended June 30, 2002, respectively, and $25.1 million and $40.8 million for the three and six months ended June 30, 2001, respectively, to "Accumulated deficit" in the Condensed Consolidated Balance Sheets.

New Accounting Standards

In June 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (referred to as SFAS) No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue (referred to as EITF) No. 94-3 "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)". SFAS 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, not at the date of an entity's commitment to an exit plan, as required under EITF 94-3. The provisions of SFAS 146 are effective for exit or disposal activities initiated after December 31, 2002, with earlier application encouraged. Chiron is currently analyzing the effect, if any, the adoption of this standard will have on the consolidated financial statements.

In August 2001, the Financial Accounting Standards Board issued SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS 144 supercedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," in that it excludes goodwill from its impairment scope and allows for different approaches in cash flow estimation. However, SFAS 144 retains the fundamental provisions of SFAS 121 for recognition and measurement of the impairment of (a) long-lived assets to be held and used and (b) long-lived assets to be disposed of other than by sale. SFAS 144 also supercedes the business segment concept in Accounting Principles

Board Opinion No. 30, "Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," in that it permits presentation of a component of an entity, whether classified as held for sale or disposed of, as a discontinued operation. However, SFAS 144 retains the requirement of Accounting Principles Board Opinion No. 30 to report discontinued operations separately from continuing operations. Chiron adopted the provisions of SFAS 144 effective January 1, 2002. The implementation of the provisions of this standard did not have a material effect on Chiron's consolidated financial position or results of operations.

In June 2001, the Financial Accounting Standards Board issued SFAS 143, "Accounting for Asset Retirement Obligations." SFAS 143 requires liability recognition for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. Chiron must adopt the provisions of SFAS 143 effective January 1, 2003, with earlier application encouraged. Chiron is currently analyzing the effect, if any, the adoption of this standard will have on the consolidated financial statements.

Chiron understands that the Financial Accounting Standards Board is considering new rules on the accounting for certain off-balance sheet lease financing. Such rules may require that, among other things, certain off-balance sheet lease financing and the related leased facilities be recorded on the balance sheet. As new information is released, Chiron will continue to monitor the impact of these rules on its June 1996 lease financing, disclosed in Note 12, "Commitments and Contingencies," in the Notes to Consolidated Financial Statements and "Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources Commitments," in Chiron's Annual Report on Form 10-K for the year ended December 31, 2001.

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.

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