ADVANCED MEDICAL OPTICS INC
Form 10-Q
August 09, 2006

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, 2006

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 001-31257

ADVANCED MEDICAL OPTICS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE (State or other jurisdiction of incorporation or organization)	**33-0986820** (I.R.S. Employer Identification No.)
1700 E. St. Andrew Place **Santa Ana, California** (Address of principal executive offices)	**92705** (Zip Code)

Registrant s telephone number, including area code **714/247-8200**

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 o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

As of July 31, 2006, there were 59,324,607 shares of common stock outstanding.

ADVANCED MEDICAL OPTICS, INC.
FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2006

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

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Advanced Medical Optics, Inc.
Unaudited Consolidated Statements of Operations
(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	June 30, 2006	**June 24, 2005**	**June 30, 2006**	**June 24, 2005**
Net sales	$ 257,041	$ 227,092	$ 495,269	$ 419,610
Cost of sales (Note 3)	92,373	87,478	179,208	157,917
Gross profit	164,668	139,614	316,061	261,693
Selling, general and administrative	105,389	97,596	200,828	181,409
Research and development	16,565	13,948	33,538	26,300
Business repositioning (Note 3)	17,720		46,974	
In-process research and development		451,450		451,450
Operating income (loss)	24,994	(423,380)	34,721	(397,466)
Non-operating expense (income):				
Interest expense	8,028	8,911	12,535	14,738
Unrealized (gain) loss on derivative instruments	2,464	(458)	2,902	(990)
Loss due to early retirement of convertible senior subordinated notes	15,798	545	15,798	545
Other, net	544	(1,413)	1,548	(1,742)
	26,834	7,585	32,783	12,551
Earning (loss) before income taxes	(1,840)	(430,965)	1,938	(410,017)
Provision for income taxes	863	7,150	2,012	14,273
Net loss	$ (2,703)	$ (438,115)	$ (74)	$ (424,290)
Net loss per share :				
Basic and Diluted	$ (0.04)	$ (9.53)	$	$ (10.17)
Weighted average number of shares outstanding:				
Basic and Diluted	67,166	45,965	67,694	41,719

See accompanying notes to unaudited consolidated financial statements.

Advanced Medical Optics, Inc.
Unaudited Consolidated Balance Sheets
(In thousands, except share data)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets		
Cash and equivalents	$ 40,843	$ 40,826
Trade receivables, net	231,602	238,761
Inventories	118,583	104,820
Deferred income taxes	66,925	66,476
Other current assets	27,129	28,122
Income taxes	10,242	
Total current assets	495,324	479,005
Property, plant and equipment, net	126,791	115,725
Deferred income taxes	12,099	12,626
Other assets	63,366	52,473
Intangibles assets, net	486,125	495,609
Goodwill	842,967	825,284
Total assets	$ 2,026,672	$ 1,980,722
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities		
Short-term borrowings	$ 155,000	$ 60,000
Accounts payable	60,592	64,045
Accrued compensation	43,844	43,406
Other accrued expenses.	85,114	90,666
Income taxes		1,434
Deferred income taxes	775	565
Total current liabilities	345,325	260,116
Long-term debt	871,105	500,000
Deferred income taxes	179,427	182,179
Other liabilities	30,445	28,365
Commitments and contingencies		
Stockholders equity		
Preferred stock, $.01 par value; 5,000,000 shares authorized; none issued		
Common stock, $.01 par value; 240,000,000 shares authorized; 59,294,365 and 67,832,010 shares issued	593	678
Additional paid-in capital	1,394,699	1,586,864
Accumulated deficit	(819,630)	(557,586)
Accumulated other comprehensive income (loss)	24,732	(19,870)
Less treasury stock, at cost (1,397 shares)	(24)	(24)
Total stockholders equity	600,370	1,010,062
Total liabilities and stockholders equity	$ 2,026,672	$ 1,980,722

See accompanying notes to unaudited consolidated financial statements.

Advanced Medical Optics, Inc.
Unaudited Consolidated Statements of Cash Flows
(In thousands)

	Six Months Ended June 30, 2006	June 24, 2005
Cash flows from operating activities:		
Net loss	$ (74)	$ (424,290)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of debt issuance costs	4,207	3,733
Depreciation and amortization	33,856	18,863
In-process research and development		451,450
Loss due to early retirement of convertible senior subordinated notes	15,798	545
Loss on investments and assets	2,481	264
Tax benefit from issuance of stock under stock plans		3,520
Excess tax benefits from stock-based compensation	(5,458)	
Unrealized loss (gain) on derivatives	2,902	(990)
Expense of compensation plan	10,262	267
Changes in assets and liabilities:		
Trade receivables, net	13,549	(15,065)
Inventories	(11,626)	(24,389)
Other current assets	(851)	3,506
Accounts payable	(6,511)	(8,631)
Accrued expenses and other liabilities	(3,474)	(30,039)
Income taxes	(1,110)	6,943
Other non-current assets and liabilities	(8,620)	4,887
Net cash provided by (used in) operating activities	45,331	(9,426)
Cash flows from investing activities:		
Acquisition of businesses, net of cash acquired		(36,867)
Additions to property, plant and equipment	(15,140)	(7,608)
Proceeds from sale of property, plant and equipment		167
Additions to capitalized internal-use software	(1,201)	(7,085)
Additions to demonstration and bundled equipment	(5,446)	(5,391)
Net cash used in investing activities	(21,787)	(56,784)
Cash flows from financing activities:		
Short-term borrowings	95,000	105,000
Repayment of long-term debt	(144,693)	(44,495)
Financing related costs	(10,284)	(2,959)
Proceeds from issuance of long-term debt	500,000	
Proceeds from issuance of common stock	29,488	10,204
Net proceeds from settlement of interest rate swaps		777
Repurchase and retirement of common stock	(500,000)	
Excess tax benefits from stock-based compensation	5,458	
Net cash (used in) provided by financing activities	(25,031)	68,527
Effect of exchange rates on cash and equivalents	1,504	(2,327)
Net increase (decrease) in cash and equivalents	17	(10
Cash and equivalents at beginning of period	40,826	49,455
Cash and equivalents at end of period	$ 40,843	$ 49,445
Supplemental non-cash investing and financing activities:		
Exchange of convertible notes into common stock	$	$ 3,000
Acquisition of VISX, Incorporated	$	$ 1,203,185

See accompanying notes to unaudited consolidated financial statements.

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Advanced Medical Optics, Inc.
Notes to Unaudited Consolidated Financial Statements

Note 1: Basis of Presentation

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments necessary (consisting only of normal, recurring adjustments) for a fair statement of the financial information contained therein. These statements do not include all disclosures required by accounting principles generally accepted in the United States of America for annual financial statements and should be read in conjunction with the audited consolidated financial statements of Advanced Medical Optics, Inc. (the Company or AMO) for the year ended December 31, 2005. The results of operations for the three and six months ended June 30, 2006 are not necessarily indicative of the results to be expected for the year ending December 31, 2006.

All material intercompany balances have been eliminated.

Stock-Based Compensation

AMO has an Incentive Compensation Plan (ICP) that provides for the granting of stock options, restricted stock and restricted stock units to directors, employees and consultants. The Company has two Employee Stock Purchase Plans (ESPP) for United States and international employees, respectively, which allow employees to purchase AMO common stock. A total of 5 million shares of common stock have been authorized for issuance under the ICP. Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R) as discussed below.

Adoption of SFAS 123R

Prior to January 1, 2006, the Company s stock-based compensation plans were accounted for under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and the disclosure only provisions of SFAS 123. Accordingly, no compensation expense was recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. The fair value, as determined on the date of grant, of restricted stock awards was recognized as compensation expense ratably over the respective vesting period. Additionally, the ESPP qualified as non-compensatory plans under APB 25; therefore, no compensation cost was recorded in relation to the discount offered to employees for purchases made under the ESPP. In addition, the Company s unearned compensation balance at January 1, 2006 was reclassified to additional paid-in capital upon the adoption of SFAS 123R.

On January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R, requiring recognition of expenses equivalent to the fair value of stock-based compensation awards. The Company has elected to use the modified prospective application transition method as permitted by SFAS 123R and therefore has not restated the financial results reported in prior periods. Under this transition method, stock-based compensation expense for the three and six months ended June 30, 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, as adjusted for estimated forfeitures. Compensation expense for all stock-based compensation awards granted subsequent to January 1, 2006 are based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R.

Additionally, under SFAS 123R, the ESPP is considered a compensatory plan and requires recognition of compensation expense for purchases of common stock made under the ESPP. The Company recognizes compensation expense for stock option and ESPP awards on a straight-line basis over the vesting period. Compensation expense related to the restricted stock and restricted stock units is recognized over the requisite service periods of the awards, consistent with the Company s practices under SFAS 123 prior to January 1, 2006.

Stock-Based Compensation Expense

Total stock-based compensation expense included in the unaudited consolidated statements of operations for the three and six months ended June 30, 2006 is as follows (in thousands):

	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of sales	$ 617	$ 1,157
Operating Expenses -		
Research and development	577	1,057
Selling, general and administrative	3,997	8,048
	4,574	9,105
Pre-tax expense	5,191	10,262
Income tax benefit	(1,704)	(3,387)
Net of tax expense	$ 3,487	$ 6,875

At June 30, 2006, total pre-tax compensation costs related to unvested stock-based awards granted to employees and directors under the Company s stock option plan, ESPP and restricted stock awards which are not yet recognized were approximately $36.6 million, net of estimated forfeitures. These costs are expected to be recognized over a weighted-average period of 3.0 years.

Net cash proceeds from the exercise of stock options were $27.1 million and $8.1 million for the six month periods ended June 30, 2006 and June 24, 2005, respectively. In accordance with SFAS 123R, the cash flows resulting from excess tax benefits (tax benefits related to the excess of proceeds from employees exercises of stock options over the stock-based compensation cost recognized for those options) are classified as financing cash flows in the Company s unaudited consolidated statement of cash flows. During the six months ended June 30, 2006, the Company recorded $5.5 million of excess tax benefits as a financing cash inflow. Prior to the adoption of SFAS 123R, excess tax benefits of $3.5 million during the six months ended June 24, 2005 were classified as an operating cash inflow.

The Company issues new shares to satisfy option exercises.

Determining Fair Value

Valuation Method - The Company estimates the fair value of stock options granted and ESPP purchase rights using the Black-Scholes option-pricing model and a single option award approach.

Expected Term - The expected term represents the period the Company s stock-based awards are expected to be outstanding and was determined based on historical experience with similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of its stock-based awards.

Expected Volatility - The computation of expected volatility is based on a combination of historical and market-based implied volatility. Implied volatility is based on publicly traded options of the Company s common stock with a term of one year or greater.

Risk-Free Interest Rate - The risk-free interest rate used in the Black-Scholes valuation method is based on the implied yield currently available on U.S. Treasury securities with an equivalent remaining term.

Expected Dividend - No dividends are expected to be paid.

Estimated Forfeitures - When estimating forfeitures, the Company considers voluntary termination behavior as well as analysis of actual option forfeitures.

The fair value of the Company s stock based compensation granted to employees for the three and six months ended June 30, 2006 was estimated using the following weighted-average assumptions:

	Incentive Compensation Plans		Employee Stock Purchase Plans	
Expected life in years	6.1		0.5	
Expected volatility	28.9	%	32.9	%
Risk-free interest rate	5.0	%	5.0	%
Expected dividends				
Weighted average fair value	$ 17.66		$ 11.51	

Stock Options

Stock options granted to employees are generally exercisable at a price equal to the fair market value of the common stock on the date of the grant and vest at a rate of 25% per year beginning twelve months after the date of grant. Grants under these plans expire ten years from the date of grant.

The following is a summary of stock option activity (in thousands, except per share amounts):

	Number of Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term in Years	Aggregate Intrinsic Value
Outstanding at December 31, 2005	8,858		$ 22.79		
Granted	634		45.26		
Exercised	(1,264	)	21.41		
Forfeitures and cancellations	(60	)	31.44		
Expirations	(6	)	19.97		
Outstanding at June 30, 2006	8,162		$ 24.69	6.6	$ 212,270
Vested and expected to vest at June 30, 2006	8,044		$ 24.57	6.7	$ 210,188
Exercisable at June 30, 2006	5,448		$ 20.58	5.9	$ 164,083

The aggregate intrinsic value in the table above represents the difference between the exercise price of the underlying awards and the quoted price of the company s common stock for the options that were in-the-money at June 30, 2006. During the six months ended June 30, 2006, the aggregate intrinsic value of options exercised under the Company s stock option plans was $30.3 million determined as of the date of option exercise.

Employee Stock Purchase Plans

Under the ESPP, eligible employees may authorize payroll deductions of up to 10% of their regular base salary to purchase shares at the lower of 85% of the closing price of the Company s common stock on the first or last day of the six-month purchase period. In the second quarter of 2006, 78,000 shares of common stock were issued under the ESPP in the aggregate amount of $2.4 million as the most recent purchase period ended on April 28, 2006. As of June 30, 2006 employee withholdings under the ESPP aggregated $0.8 million.

Restricted Stock

Restricted stock awards are granted at a price equal to the fair market value of the common stock on the date of the grant, subject to forfeiture if employment terminates prior to the release of restrictions, which is generally three years from the date of grant. During this restriction period, ownership of the shares cannot be transferred. Restricted stock has the same cash dividend and voting rights as other common stock and is considered to be currently issued and outstanding. The cost of the awards, determined to be the fair market value of the shares at the date of grant, is expensed ratably over the period the restrictions lapse.

The following table summarizes the restricted stock award activity for the six months ended June 30, 2006 (in thousands, except per share amounts):

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested stock at December 31, 2005	101	$ 38.79
Granted	275	49.67
Vested	(37)	38.23
Forfeited	(2)	38.43
Nonvested stock at June 30, 2006	337	$ 47.73

Performance-Based Awards

In February 2006, the Company s Board of Directors approved a 2006 performance award program under the Company s incentive compensation plan (the 2006 Program), which provides the opportunity for certain executives to earn long-term incentive compensation awards based upon specified measures. The potential maximum aggregate award value for the 2006 program is $2.7 million. The award determination will be based upon the Total Shareholder Return (TSR) (the increase or decrease in the Company s common stock price) over a two-year period beginning January 1, 2005 compared to a peer group composed of various entities within the bio-technology and medical device industries. Awards will have been determined to be earned if the Company s TSR is in excess of the 50th percentile of the peer group. When the TSR equals the 75th percentile of the peer group, the maximum amount will have been earned. Awards are to be settled in a number of restricted stock shares or units equal to the value of the award amount divided by the fair market value of the Company s common stock on the date the performance criteria is deemed to have been met. The restricted stock shares or units will have the same terms and conditions as other restricted shares or units issued under the Company s ICP. The estimated fair value of the 2006 Program was $0.8 million on the grant date using a lattice-based valuation model. Compensation expense is being recognized over a four-year period from the program approval date through the end of the expected vesting period of the restricted stock awards. The associated compensation expense during the three months and six months ended June 30, 2006 was less than $0.1 million.

Pro-forma Disclosures under SFAS 123 for Periods Prior to Fiscal 2006

The following table illustrates the effect on net loss and net loss per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation during the three and six months period ended June 24, 2005 (in thousands, except per share amounts):

	Three Months Ended June 24, 2005	Six Months Ended June 24, 2005
Net loss, as reported	$ (438,115)	$ (424,290)
Stock-based compensation expense included in reported net earnings, net of tax	119	163
Stock-based compensation expense determined under fair value based method, net of tax	(2,579)	(4,876)
Pro forma net loss	$ (440,575)	$ (429,003)
Loss per share as reported:		
Basic and diluted	$ (9.53)	$ (10.17)
Pro forma loss per share:		
Basic and diluted	$ (9.59)	$ (10.28)

For the purpose of the weighted average estimated fair value calculations, the fair value of the Company s stock based compensation granted to employees for the three and six months ended June 24, 2005 was estimated using the following weighted-average assumptions:

	Incentive Compensation Plans		Employee Stock Purchase Plans	
Expected life in years	5.0		0.5	
Expected volatility	36.0	%	44.13	%
Risk-free interest rate	3.8	%	3.2	%
Expected dividends				
Weighted average fair value	$ 14.49		$ 9.84	

Note 2: Acquisition of VISX, Incorporated (VISX)

On May 27, 2005, pursuant to the Agreement and Plan of Merger (Merger Agreement), dated as of November 9, 2004, as amended, by and among AMO, Vault Merger Corporation, a wholly owned subsidiary of AMO, and VISX, AMO completed its acquisition of VISX, for total consideration of approximately $1.38 billion, consisting of approximately 27.8 million shares of AMO common stock, the fair value of VISX stock options converted to AMO stock options and approximately $176.2 million in cash (VISX Acquisition). VISX products include the *VISX STAR* Excimer Laser System, the *VISX WaveScan* System and *VISX* treatment cards. As a result of the VISX Acquisition, the Company became a leader in the design and development of proprietary technologies and systems for laser vision correction of refractive vision disorders.

The VISX Acquisition has been accounted for as a purchase business combination. Under the purchase method of accounting, the assets acquired and liabilities assumed are recorded at the date of acquisition at their respective fair values.

The following unaudited pro forma information assumes the VISX Acquisition occurred on January 1, 2005. These unaudited pro forma results have been prepared for informational purposes only and do not purport to represent what the results of operations would have been had the VISX Acquisition occurred as of the date indicated, nor of future results of operations. The unaudited pro forma results for the three and six months ended June 24, 2005 are as follows (in thousands, except per share data):

	Three Months Ended June 24, 2005	**Six Months Ended June 24, 2005**
Net sales:		
Cataract/Implant	$ 127,726	$ 244,456
Laser Vision Correction	45,123	98,404
Eye Care	83,073	156,919
	$	