

**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, 2002

[] **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 1-9913

KINETIC CONCEPTS, INC.

(Exact name of registrant as specified in its charter)

Texas
(State of Incorporation)

74-1891727
(I.R.S. Employer Identification No.)

8023 Vantage Drive
San Antonio, Texas 78230
Telephone Number: (210) 524-9000
 (Address, including zip code, and telephone number, including area code,
 of registrant's principal executive offices)

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.

Common Stock: 70,928,040 shares as of August 1, 2002

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

KINETIC CONCEPTS, INC. AND SUBSIDIARIES Condensed Consolidated Balance Sheets (in thousands)

	June 30, <u>2002</u> (unaudited)	December 31, <u>2001</u>
Assets:		
Current assets:		
Cash and cash equivalents	\$ 9,368	\$ 199
Accounts receivable, net	138,452	121,364
Inventories, net	41,335	40,166
Prepaid expenses and other current assets	10,188	9,337
Total current assets	<u>199,343</u>	<u>171,066</u>
Net property, plant and equipment	103,175	89,981
Loan issuance cost, less accumulated amortization of \$10,791 in 2002 and \$9,634 in 2001	7,445	8,602
Goodwill, less accumulated amortization of \$26,785 in both 2002 and 2001	46,340	43,035
Other assets, less accumulated amortization of \$6,581 in 2002 and \$5,562 in 2001	30,718	30,509
	<u>\$ 387,021</u>	<u>\$ 343,193</u>
Liabilities and Shareholders' Deficit:		
Current liabilities:		
Accounts payable	\$ 9,486	\$ 8,429
Accrued expenses	43,516	48,108
Current installments of long-term obligations	13,050	2,750
Current installments of capital lease obligations	162	171
Derivative financial instruments	1,815	2,512
Income taxes payable	16,836	8,761
Total current liabilities	<u>84,865</u>	<u>70,731</u>
Long-term obligations, net of current installments	510,325	503,875
Capital lease and other obligations, net of current installments	924	549
Deferred income taxes, net	3,508	4,363
	<u>599,622</u>	<u>579,518</u>
Shareholders' deficit:		
Common stock; issued and outstanding 70,928 in 2002 and 70,925 in 2001	71	71
Retained deficit	(206,343)	(226,381)
Accumulated other comprehensive loss	(6,329)	(10,015)
	<u>(212,601)</u>	<u>(236,325)</u>
	<u>\$ 387,021</u>	<u>\$ 343,193</u>

See accompanying notes to condensed consolidated financial statements.

KINETIC CONCEPTS, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Earnings
(in thousands, except per share data)
(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Revenue:				
Rental and service	\$ 107,595	\$ 87,012	\$ 209,010	\$ 168,356
Sales and other	29,513	21,611	55,239	43,504
Total revenue	137,108	108,623	264,249	211,860
Rental expenses	67,116	53,191	128,906	104,145
Cost of goods sold	11,764	7,748	21,369	15,883
	78,880	60,939	150,275	120,028
Gross profit	58,228	47,684	113,974	91,832
Selling, general and administrative expenses	32,080	26,929	63,272	50,820
Operating earnings	26,148	20,755	50,702	41,012
Interest income	99	150	109	190
Interest expense	(10,384)	(11,360)	(20,692)	(23,294)
Foreign currency gain (loss)	2,992	(321)	2,448	(1,246)
Earnings before income taxes	18,855	9,224	32,567	16,662
Income taxes	7,259	3,874	12,538	6,998
Net earnings	\$ 11,596	\$ 5,350	\$ 20,029	\$ 9,664
Earnings per common share	\$ 0.16	\$ 0.08	\$ 0.28	\$ 0.14
Earnings per common share -- assuming dilution	\$ 0.15	\$ 0.07	\$ 0.26	\$ 0.13
Average common shares:				
Basic (weighted average outstanding shares)	70,926	70,915	70,926	70,915
Diluted (weighted average outstanding shares)	77,683	73,056	77,688	73,066

See accompanying notes to condensed consolidated financial statements.

KINETIC CONCEPTS, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Six months ended	
	<u>June 30,</u>	
	<u>2002</u>	<u>2001</u>
Cash flows from operating activities:		
Net earnings	\$ 20,029	\$ 9,664
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	15,486	14,609
Amortization	2,177	3,208
Provision for uncollectible accounts receivable	4,861	4,634
Change in assets and liabilities net of effects from purchase of subsidiaries and unusual items:		
Increase in accounts receivable, net	(20,580)	(19,427)
Increase in inventories	(498)	(9,201)
Decrease (increase) in prepaid expenses and other	(851)	846
Increase in accounts payable	1,039	3,488
Decrease in accrued expenses	(4,331)	(1,371)
Increase in income taxes payable	7,952	5,495
Decrease in deferred income taxes, net	(1,357)	(2,020)
Net cash provided by operating activities	<u>23,927</u>	<u>9,925</u>
Cash flows from investing activities:		
Additions to property, plant and equipment	(30,500)	(19,386)
Decrease (increase) in inventory to be converted into equipment for short-term rental	1,100	(700)
Dispositions of property, plant and equipment	1,799	981
Businesses acquired in purchase transactions, net of cash acquired	(3,596)	-
Increase in other assets	(1,172)	(1,720)
Net cash used by investing activities	<u>(32,369)</u>	<u>(20,825)</u>
Cash flows from financing activities:		
Borrowings of notes payable, long-term, capital lease and other obligations	17,088	11,505
Proceeds from exercise of stock options	8	-
Net cash provided by financing activities	<u>17,096</u>	<u>11,505</u>
Effect of exchange rate changes on cash and cash equivalents	515	(525)
Net increase in cash and cash equivalents	<u>9,169</u>	<u>80</u>
Cash and cash equivalents, beginning of period	<u>199</u>	<u>2,139</u>
Cash and cash equivalents, end of period	<u>\$ 9,368</u>	<u>\$ 2,219</u>
Supplemental disclosure of cash flow information:		
Cash paid during the first six months for:		
Interest	\$ 19,526	\$ 22,224
Income taxes	\$ 9,756	\$ 4,414

See accompanying notes to condensed consolidated financial statements.

KINETIC CONCEPTS, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

(1) BASIS OF PRESENTATION

The financial statements presented herein include the accounts of Kinetic Concepts, Inc. and all subsidiaries (the "Company"). The unaudited condensed consolidated financial statements appearing in this quarterly report on Form 10-Q should be read in conjunction with the financial statements and notes thereto included in the Company's latest annual report on Form 10-K. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. The foregoing financial information reflects all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations for the interim periods presented. Interim period operating results are not necessarily indicative of the results to be expected for the full fiscal year. Certain reclassifications of amounts related to the prior year have been made to conform with the 2002 presentation. For additional information regarding Critical Accounting Policies, refer to Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, beginning on page 26.

(2) ACQUISITIONS

In 1996, the Company acquired a 26% interest in the capital stock of Polymedics N.V., ("Polymedics"), a Belgium manufacturer of foam used in certain V.A.C. dressings which was accounted for on a cost basis. During the first quarter of 2002, the Company acquired the remaining 74% of Polymedics stock for approximately \$3.6 million in cash at which time the financial position and results of operations were reflected on a consolidated basis. Polymedics' operating results did not have a material impact on the Company's results of operations for 2002 or 2001.

(3) ACCOUNTS RECEIVABLE COMPONENTS

Accounts receivable consist of the following (dollars in thousands):

	June 30, <u>2002</u>	December 31, <u>2001</u>
Trade accounts receivable:		
Facilities / dealers	\$ 84,576	\$ 73,088
Third-party payers:		
Medicare / Medicaid	25,093	22,006
Managed Care commercial and other	47,256	40,375
	<u>156,925</u>	<u>135,469</u>
Medicare V.A.C. receivables prior to October 1, 2000	14,351	14,351
Employee and other receivables	2,113	2,075
	<u>173,389</u>	<u>151,895</u>
Less: Allowance for doubtful receivables	(20,586)	(16,180)
Allowance for Medicare V.A.C. receivable prior to October 1, 2000	(14,351)	(14,351)
	<u>\$ 138,452</u>	<u>\$ 121,364</u>

(4) **INVENTORY COMPONENTS**

Inventories are stated at the lower of cost (first-in, first-out) or market (net realizable value). Inventories are comprised of the following (dollars in thousands):

	June 30, 2002	December 31, 2001
Finished goods	\$ 16,476	\$ 11,244
Work in process	2,913	3,540
Raw materials, supplies and parts	32,635	37,081
	<u>52,024</u>	<u>51,865</u>
Less: Amounts expected to be converted into equipment for short-term rental	(9,700)	(10,800)
Reserve for excess and obsolete inventory	(989)	(899)
	<u>\$ 41,335</u>	<u>\$ 40,166</u>

(5) **LONG-TERM OBLIGATIONS**

Long-term obligations consist of the following (dollars in thousands):

	June 30, 2002	December 31, 2001
Senior Credit Facilities:		
Revolving bank credit facility	\$ -	\$ 11,800
Term loans:		
Tranche A due 2003	27,500	27,500
Tranche B due 2004	85,950	86,400
Tranche C due 2005	85,950	86,400
Tranche D due 2006	94,050	94,525
Tranche E due 2005	29,925	-
	<u>323,375</u>	<u>306,625</u>
9 5/8% Senior Subordinated Notes Due 2007	200,000	200,000
	<u>523,375</u>	<u>506,625</u>
Less current installments	(13,050)	(2,750)
	<u>\$ 510,325</u>	<u>\$ 503,875</u>

Senior Credit Facilities

On April 4, 2002, the Company entered into a Second Amended and Restated Credit and Guarantee Agreement (the "Amended Credit Agreement"). The Amended Credit Agreement funded a \$30 million Tranche E Term Loan as part of a refinancing of the Company's Senior Secured Credit Facilities. Proceeds from the Tranche E Term Loan were used to pay down existing indebtedness of \$29.6 million under the Revolving Credit Facility with the remaining proceeds used to pay fees and expenses associated with the transaction.

Indebtedness under the Senior Credit Facilities, as amended and restated, including the Revolving Credit Facility (other than certain loans under the Revolving Credit Facility designated in foreign currency) and the Term Loans, initially bear interest at a rate based upon (i) the Base Rate (defined as the higher of (x) the rate of interest publicly announced by Bank of America as its "reference rate" or (y) the federal funds effective rate from time to time plus 0.50%), plus 1.75% in respect of the

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Tranche A Term Loans and the loans under the Revolving Credit Facility (the "Revolving Loans"), 2.00% in respect of the Tranche B Term Loans, 2.25% in respect of the Tranche C and Tranche E Term Loans and 2.125% in respect of the Tranche D Term Loans, or at the Company's option, (ii) the Eurodollar Rate (as defined in the Senior Credit Facility Agreement) for one, two, three or six months, in each case plus 2.75% in respect of Tranche A Term Loans and Revolving Loans, 3.00% in respect of Tranche B Term Loans, 3.25% in respect of the Tranche C and Tranche E Term Loans and 3.125% in respect to the Tranche D Term Loans. Certain Revolving Loans designated in foreign currency will initially bear interest at a rate based upon the cost of funds for such loans plus 2.75%. Performance-based reductions of the interest rates under the Term Loans and the Revolving Loans are available.

In January 2001, the Company entered into an interest rate swap which fixed the base-borrowing rate on \$150 million of the Company's variable rate debt at 5.36% and was effective from January 5, 2001 through December 31, 2001. On October 1, 2001, the Company terminated its \$150 million, 5.36% interest rate swap to take advantage of lower interest rates and entered into two new interest rate swaps, which resulted in additional interest expense of \$1.1 million in the fourth quarter of 2001. One interest rate swap fixes the base-borrowing rate on \$150 million of the Company's variable rate debt at 3.57% per annum and is effective October 1, 2001 through December 31, 2002. The second interest rate swap fixes the rate on an additional \$100 million of the Company's variable rate debt at 2.99% annually and is effective October 1, 2001 through December 31, 2002. As of June 30, 2002, these agreements effectively fix the base-borrowing rate on 77.3% of the Company's variable rate debt. As a result of the interest rate protection agreements, the Company recorded additional interest expense of approximately \$740,000 and \$96,000 in the first six months of 2002 and 2001, respectively.

The Term Loans, other than Tranches D and E, are subject to quarterly amortization payments which began on March 31, 1998. The Tranche D Term Loan amortizes at 1% per year beginning September 30, 2001 through December 31, 2005 with a final payment of \$90.7 million due March 31, 2006. The Tranche E Term Loan amortizes at 1% per year beginning June 30, 2002 with a final payment of \$29.0 million due December 31, 2005. The Revolving Loans may be repaid and reborrowed. At June 30, 2002, the Company had three Letters of Credit in the amount of \$5.5 million, and the aggregate availability under the Revolving Credit facility was \$44.5 million.

Indebtedness of the Company under the Senior Credit Facilities Agreement is guaranteed by certain of the subsidiaries of the Company and is secured by (i) a first priority security interest in all of the tangible and intangible assets of the Company and its domestic subsidiaries (subject to certain customary exceptions), including, without limitation, intellectual property and real estate owned by the Company and its subsidiaries, (ii) a first priority perfected pledge of all capital stock of the Company's domestic subsidiaries and (iii) a first priority perfected pledge of up to 65% of the capital stock of foreign subsidiaries owned directly by the Company or its domestic subsidiaries.

The Senior Credit Agreement requires the Company to meet certain financial tests, including minimum levels of EBITDA (as defined therein), minimum interest coverage, maximum leverage ratio and capital expenditures. The Senior Credit Agreement also contains covenants which, among other things, limit the Company's ability to: incur additional indebtedness, make investments, announce or pay dividends, make loans and advances, make capital expenditures, enter into transactions with affiliates, dispose of its assets, enter into acquisitions, mergers or consolidation transactions, make prepayments on other indebtedness, create or permit to be created any liens on any of its properties, or undertake certain other matters customarily restricted in such agreements. At June 30, 2002, the Company is in compliance with all applicable covenants.

The Senior Credit Agreement also contains customary events of default, including payment defaults, any breach of representations and warranties, covenant defaults, cross-defaults to certain other indebtedness, certain events of bankruptcy and insolvency, failures under ERISA plans, judgment defaults, any change of control of the Company and failure of any guaranty, security document, security interest or subordination provision under the Senior Credit Agreement. In addition, the Senior Credit Agreement provides for mandatory repayments, subject to certain exceptions, of the Term Loans and the Revolving Credit Facility based on certain net asset sales

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outside the ordinary course of business of the Company and its subsidiaries, the net proceeds of certain debt and equity issuances and excess cash flows.

9 5/8% Senior Subordinated Notes Due 2007

The 9 5/8% Senior Subordinated Notes (the "Notes") due 2007 are unsecured obligations of the Company, ranking subordinate in right of payment to all senior debt of the Company and will mature on November 1, 2007. Interest on the Notes accrues at the rate of 9 5/8% per annum and is payable semiannually in cash on each May 1 and November 1, to the persons who are registered Holders at the close of business on April 15 and October 15, respectively, immediately preceding the applicable interest payment date. Interest on the Notes accrues from and includes the most recent date to which interest has been paid or, if no interest has been paid, from and including the date of issuance.

As of June 30, 2002, the entire \$200.0 million of Senior Subordinated Notes was issued and outstanding. The Notes are not entitled to the benefit of any mandatory sinking fund. The Notes will be redeemable, at the Company's option, in whole at any time or in part from time to time, on and after November 1, 2002, upon not less than 30 nor more than 60 days' notice, at the following redemption prices (expressed as percentages of the principal amount thereof) if redeemed during the twelve-month period commencing on November 1 of the year set forth below, plus, in each case, accrued and unpaid interest thereon, if any, to the date of redemption.

<u>Year</u>	<u>Percentage</u>
2002	104.813%
2003	103.208%
2004	101.604%
2005 and thereafter	100.000%

At any time, or from time to time, the Company may acquire a portion of the Notes through open-market purchases. In order to effect the foregoing redemption with the proceeds of any equity offering, the Company shall make such redemption not more than 120 days after the consummation of any such equity offering.

(6) ACCOUNTING FOR GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill represents the excess purchase price over the fair value of net assets acquired. Effective January 1, 2002, the Company has applied the provisions of Statement of Financial Accounting Standards No. 142, ("SFAS 142"), *Goodwill and Other Intangible Assets* in its accounting for goodwill. Under SFAS 142, goodwill and intangible assets that have indefinite useful lives are no longer subject to amortization over an estimated useful life. Rather, goodwill and indefinite-lived intangible assets are subject to an assessment for impairment at least annually. SFAS 142 provides specific guidance for testing goodwill for impairment. Intangible assets with finite useful lives continue to be amortized over their useful lives. Goodwill and indefinite-lived intangibles were tested for impairment during the first quarter of 2002 and will be tested for impairment at least annually.

Goodwill, net of accumulated amortization, was \$46.3 million at June 30, 2002, compared to \$43.0 million at December 31, 2001. This increase relates to the acquisition of Polymedics by the Company in the first quarter of 2002 (See Note 2.). Goodwill represented 12.0% and 12.5% of total assets at June 30, 2002 and December 31, 2001, respectively. For further discussion of goodwill, see Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, Critical Accounting Policies.

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The following table shows the effect of the adoption of SFAS 142 on the Company's net income as of June 30, 2001 as if the adoption had occurred on January 1, 2001 (dollars in thousands, except per share data):

	Pro Forma	
	Three months ended June 30, 2001	Six months ended June 30, 2001
Net earnings - as reported	\$ 5,350	\$ 9,664
Amortization adjustment	843	1,686
Adjusted net earnings	<u>\$ 6,193</u>	<u>\$ 11,350</u>
Earnings per common share - as reported	\$ 0.08	\$ 0.14
Amortization adjustment	0.01	0.02
	<u>\$ 0.09</u>	<u>\$ 0.16</u>
Earnings per common share - assuming dilution - as reported	\$ 0.07	\$ 0.13
Amortization adjustment	0.02	0.03
Adjusted earnings per common share - assuming dilution	<u>\$ 0.09</u>	<u>\$ 0.16</u>

The Company has recorded amortizable intangible assets which are included in Other Assets on the Condensed Consolidated Balance Sheets. Other assets include the following (dollars in thousands):

	June 30, 2002	December 31, 2001
Patents, trademarks and other	\$ 10,385	\$ 10,083
Accumulated amortization	(6,581)	(5,562)
	<u>3,804</u>	<u>4,521</u>
Other tangible, noncurrent assets, net	<u>26,914</u>	<u>25,988</u>
Total other assets, net	<u>\$ 30,718</u>	<u>\$ 30,509</u>

Amortization expense, related to finite-lived intangibles, was approximately \$123,000 and \$150,000 for the three months ended June 30, 2002 and 2001, respectively, and approximately \$1.0 million and \$327,000 for the six months ended June 30, 2002 and 2001, respectively. The Company amortizes these intangible assets over 5 to 17 years, depending on the estimated economic life of the individual asset. The following table shows the estimated amortization expense, in total for all finite-lived intangible assets, to be incurred over the next five years (dollars in thousands):

Year ended December 31,	Estimated Amortization Expense
2002	\$ 1,008
2003	\$ 291
2004	\$ 237
2005	\$ 226
2006	\$ 226

(7) **EARNINGS PER SHARE**

The following table sets forth the reconciliation from basic to diluted average common shares and the calculations of net earnings per common share. Net earnings for basic and diluted calculations do not differ (dollars in thousands, except per share data):

	Three months ended <u>June 30,</u>		Six months ended <u>June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Net earnings	\$11,596	\$ 5,350	\$20,029	\$ 9,664
Average common shares:				
Basic (weighted-average outstanding shares)	70,926	70,915	70,926	70,915
Dilutive potential common shares from stock options	6,757	2,141	6,762	2,151
Diluted (weighted-average outstanding shares)	77,683	73,056	77,688	73,066
Earnings per common share	\$ 0.16	\$ 0.08	\$ 0.28	\$ 0.14
Earnings per common share - assuming dilution	\$ 0.15	\$ 0.07	\$ 0.26	\$ 0.13

(8) **COMMITMENTS AND CONTINGENCIES**

The Company is a party to several lawsuits arising in the ordinary course of its business. Provisions have been made in the Company's financial statements for estimated exposures related to these lawsuits. In the opinion of management, the disposition of these matters will not have a material adverse effect on the Company's business, financial condition or results of operations. (See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations, Legal Proceedings.)

The manufacturing and marketing of medical products necessarily entails an inherent risk of product liability claims. The Company currently has certain product liability claims pending for which provision has been made in the Company's financial statements. Management believes that resolution of these claims will not have a material adverse effect on the Company's business, financial condition or results of operations. The Company has not experienced any significant losses due to product liability claims and management believes that the Company currently maintains adequate liability insurance coverage.

Other than commitments for new product inventory, including disposable "for sale" products of \$7.7 million, the Company has no material long-term capital commitments and can adjust its level of capital expenditures as circumstances dictate.

(9) OTHER COMPREHENSIVE INCOME

The components of other comprehensive income are as follows (dollars in thousands):

	Three months ended June 30,	
	2002	2001
Net earnings	\$ 11,596	\$ 5,350
Foreign currency translation adjustment	4,238	(639)
Net derivative income (loss), net of taxes of \$394 in 2002 and \$153 in 2001	(732)	(285)
Reclassification adjustment for (gains) losses included in income, net of taxes of \$206 in 2002 and \$65 in 2001	383	120
Reclassification adjustment for loss recognized on termination of interest rate swap, net of taxes of \$70	(130)	-
Other comprehensive income	<u>\$ 15,355</u>	<u>\$ 4,546</u>

	Six months ended June 30,	
	2002	2001
Net earnings	\$ 20,029	\$ 9,664
Foreign currency translation adjustment	3,492	(2,265)
Net derivative income (loss), net of taxes of \$194 in 2002 and \$459 in 2001	(361)	(852)
Reclassification adjustment for (gains) losses included in income, net of taxes of \$438 in 2002 and \$34 in 2001	813	62
Reclassification adjustment for loss recognized on termination of interest rate swap, net of taxes of \$148	(258)	-
Other comprehensive income	<u>\$ 23,715</u>	<u>\$ 6,609</u>

The earnings associated with certain of the Company's foreign affiliates are considered to be permanently invested and no provision for U.S. Federal and State income taxes on these earnings or translation adjustments has been made.

As of June 30, 2002, derivative financial instruments valued at a liability of \$1.8 million were recorded as a result of the Company's adoption of FASB Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities." This liability is based upon the valuation of the Company's interest rate protection agreements associated with its Senior Credit Facilities. (See Notes 5 and 11.)

(10) **SEGMENT AND GEOGRAPHIC INFORMATION**

The Company is principally engaged in the rental and sale of innovative therapeutic systems throughout the United States and in 15 primary countries and Puerto Rico internationally.

The Company defines its business segments based on geographic management responsibility. The Company has two reportable segments: USA, which includes operations in the United States, and International, which includes operations for all international units. The Company measures segment profit as operating earnings, which is defined as income before interest income or expense, foreign currency gains and losses, income taxes and minority interest. All intercompany transactions are eliminated in computing revenues, operating earnings and assets. Information on segments and a reconciliation of consolidated totals are as follows (dollars in thousands):

	Three months ended <u>June 30,</u>		Six months ended <u>June 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Revenue:				
USA	\$ 105,803	\$ 84,533	\$ 204,982	\$ 163,196
International	31,305	24,090	59,267	48,664
	<u>\$ 137,108</u>	<u>\$ 108,623</u>	<u>\$ 264,249</u>	<u>\$ 211,860</u>
Operating Earnings:				
USA	\$ 32,981	\$ 25,872	\$ 64,997	\$ 50,852
International	4,647	5,057	8,790	10,248
Other (1):				
Executive	(3,151)	(3,652)	(4,958)	(7,068)
Finance	(3,907)	(3,418)	(7,578)	(6,479)
Manufacturing/Engineering	(1,570)	(960)	(3,659)	(1,424)
Administration	(2,852)	(2,144)	(6,890)	(5,117)
Total Other	<u>(11,480)</u>	<u>(10,174)</u>	<u>(23,085)</u>	<u>(20,088)</u>
	<u>\$ 26,148</u>	<u>\$ 20,755</u>	<u>\$ 50,702</u>	<u>\$ 41,012</u>

- (1) Other includes general headquarter expenses which are not allocated to the individual segments and are included in selling, general and administrative expenses within the Company's Condensed Consolidated Statements of Earnings (see page 5).

(11) **DERIVATIVE FINANCIAL STATEMENTS**

The Company adopted Statement of Financial Accounting Standards No. 133 (SFAS 133), "Accounting for Derivative Instruments and Hedging Activities," and its amendments, Statements 137 and 138, on January 1, 2001. SFAS 133 requires that all derivative instruments be recorded on the balance sheet at fair value. The Company has designated its interest rate swap agreements as cash flow hedge instruments. The swap agreements are used to manage exposure to interest rate movement by effectively changing the variable interest rate to a fixed rate. Changes in the effective portion of the fair value of the interest rate swap agreement will be recognized in other comprehensive income, net of tax effects, until the hedged item is recognized into earnings, whereas the ineffective portion is recognized into income as incurred.

The Company entered into a \$150.0 million swap agreement on January 5, 2001. In accordance with the transition provisions of SFAS 133, no cumulative effect of an accounting change was necessary. The \$150.0 million swap was designated as a cash flow hedge of interest payments through December 31, 2001 and qualified for the shortcut method of accounting for such derivatives. On October 1, 2001, the Company terminated its \$150.0 million, 5.36% interest rate swap to take

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advantage of lower interest rates, which resulted in additional interest expense of \$1.1 million in the fourth quarter of 2001. The new \$150.0 million swap was designated as a hedge of interest payments effective October 1, 2001 through December 31, 2002. The amount included in other comprehensive income as of September 30, 2001 continues to be recognized over the original date through which interest payments were hedged, as the hedged item (interest payments) continues to exist. Additionally, accumulated other comprehensive loss was reduced by approximately \$550,000 as a loss on termination of interest rate swap during 2001, and increased by approximately \$260,000 during 2002.

Although no cash was exchanged, the new \$150.0 million swap does not qualify for the shortcut method because the fair value of the new swap was not zero at inception (it had a negative value). The Company has elected to use the "hypothetical derivative" method to measure effectiveness, which allows the Company to use the change in the fair value of a "hypothetical derivative" (one which had no fair value at inception with terms mirroring the actual derivative that would be assumed to be perfectly effective) as a proxy for the change in the expected fair value of the hedged transactions. As of June 30, 2002, the hedged cash flows offset the change in the fair value of expected cash flows by 103.5%; therefore, the hedge was deemed "highly effective". Hedge ineffectiveness, of approximately \$11,000 was immaterial and recognized as a decrease of interest expense in the second quarter of 2002 and approximately \$1,000 in the first half of 2002. The Company will continue to mark the \$150.0 million derivative to its fair value and record an offsetting amount (based upon the lesser of the cumulative change in the derivative or the cumulative change in the hypothetical derivative) in other comprehensive income, net of any related tax effects. At June 30, 2002, the fair value of the swap agreement is in an unfavorable position and was adjusted to a liability of \$1,268,000. Accumulated other comprehensive loss was adjusted \$824,000 for the net derivative liability and deferred income taxes payable was adjusted \$444,000 for the tax benefit related to the derivative liability. The reclassification adjustment for the loss recognized on the termination of the interest rate swap increased accumulated other comprehensive income liability by \$130,000 (\$200,000 less taxes of \$70,000) in the second quarter of 2002.

Also on October 1, 2001, the Company entered into a new \$100.0 million swap, which was designated as a cash flow hedge of interest payments through December 31, 2002 and qualified for the shortcut method of accounting for such derivatives. The critical terms of the interest rate swap agreements and the interest-bearing debt associated with the swap agreements are the same. As of June 30, 2002, the fair value of the swap agreement is in an unfavorable position and was adjusted to a liability of \$548,000. Accumulated other comprehensive loss was adjusted \$356,000 for the net derivative liability and deferred income taxes payable was adjusted \$192,000 for the tax benefit related to the derivative liability. Because the swap agreement is deemed to be an effective cash flow hedge, there will be no income statement impact related to the hedge ineffectiveness. (See Note 9.)

(12) SUBSEQUENT EVENTS

In August 2002, the Company sold its headquarters facility under a sales/leaseback arrangement. The facility was sold for \$18.2 million, net of selling costs, resulting in a deferred gain of approximately \$10 million. The deferred gain will be amortized over the term of the lease. The initial lease term is 10 years and requires annual minimum lease payments ranging from \$3.2 million to \$3.8 million.

(13) GUARANTOR CONDENSED CONSOLIDATING FINANCIAL STATEMENTS

Kinetic Concepts, Inc. issued \$200 million in subordinated debt securities to finance a tender offer to purchase certain of its common shares outstanding. In connection with the issuance of these securities, certain of its wholly-owned subsidiaries (the "guarantor subsidiaries") act as guarantors. Certain other subsidiaries (the "non-guarantor subsidiaries") do not guarantee such debt. The guarantor subsidiaries are wholly owned by the Company and the guarantees are full, unconditional, and joint and several. The Company has not presented separate financial statements and other disclosures concerning the Subsidiary Guarantors because management has determined that such information is not material to investors.

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Indebtedness of the Company under the Senior Credit Facilities Agreement is guaranteed by certain of the subsidiaries of the Company and is secured by (i) a first priority security interest in all, subject to certain customary exceptions, of the tangible and intangible assets of the Company and its domestic subsidiaries, including, without limitation, intellectual property and real estate owned by the Company and its subsidiaries, (ii) a first priority perfected pledge of all capital stock of the Company's domestic subsidiaries and (iii) a first priority perfected pledge of up to 65% of the capital stock of foreign subsidiaries owned directly by the Company or its domestic subsidiaries. The Senior Credit Agreement contains covenants which, among other things, limit the incurrence of additional indebtedness, investments, dividends, loans and advances, capital expenditures, transactions with affiliates, asset sales, acquisitions, mergers and consolidations, prepayments of other indebtedness, liens and encumbrances and other matters customarily restricted in such agreements. The net assets of the guarantor subsidiaries are detailed on pages 17 and 18.

The following tables present the condensed consolidating balance sheets of Kinetic Concepts, Inc. as a parent company, its guarantor subsidiaries and its non-guarantor subsidiaries as of June 30, 2002 and December 31, 2001 and the related condensed consolidating statements of earnings for the three and six-month periods ended June 30, 2002 and 2001, and the condensed consolidating statements of cash flows for the six-month periods ended June 30, 2002 and 2001, respectively. (See pages 17 to 24).

**Condensed Consolidating Guarantor, Non-Guarantor And
Parent Company Balance Sheet
June 30, 2002
(in thousands)
(unaudited)**

	Kinetic Concepts, Inc. Parent Company <u>Borrower</u>	Guarantor Sub- sidiaries	Non- Guarantor Sub- sidiaries	Reclassi- fications and Elimi- nations	Kinetic Concepts, Inc. and Sub- sidiaries
ASSETS:					
Current assets:					
Cash and cash equivalents	\$ -	\$ 1,534	\$ 7,834	\$ -	\$ 9,368
Accounts receivable, net	-	113,582	32,600	(7,730)	138,452
Inventories, net	-	22,405	18,930	-	41,335
Prepaid expenses and other current assets	-	3,920	6,268	-	10,188
Total current assets	-	141,441	65,632	(7,730)	199,343
Net property, plant and equipment	-	100,529	16,460	(13,814)	103,175
Loan issuance cost, net	-	7,445	-	-	7,445
Goodwill, net	-	38,681	7,659	-	46,340
Other assets, net	-	29,409	1,309	-	30,718
Intercompany investments and advances	(212,601)	511,635	15,422	(314,456)	-
	\$ (212,601)	\$ 829,140	\$ 106,482	\$ (336,000)	\$ 387,021
LIABILITIES AND SHARE- HOLDERS EQUITY (DEFICIT):					
Accounts payable	\$ -	\$ 5,250	\$ 4,236	\$ -	\$ 9,486
Accrued expenses	-	33,283	10,233	-	43,516
Current installments of long- term obligations	-	13,050	-	-	13,050
Intercompany payables	-	19,869	-	(19,869)	-
Current installments of capital lease obligations	-	162	-	-	162
Derivative financial instruments	-	1,815	-	-	1,815
Income taxes payable	-	11,365	5,471	-	16,836
Total current liabilities	-	84,794	19,940	(19,869)	84,865
Long-term obligations, net of current installments	-	510,325	-	-	510,325
Capital lease and other obligations, net of current installments	-	912	12	-	924
Deferred income taxes, net	-	14,283	-	(10,775)	3,508
Shareholders' equity (deficit)	(212,601)	218,826	86,530	(305,356)	(212,601)
	\$ (212,601)	\$ 829,140	\$ 106,482	\$ (336,000)	\$ 387,021

**Condensed Consolidating Guarantor, Non-Guarantor And
Parent Company Balance Sheet
December 31, 2001
(in thousands)**

	Kinetic Concepts, Inc. Parent Company <u>Borrower</u>	Guarantor Sub- sidiaries	Non- Guarantor Sub- sidiaries	Reclassi- fications and Elimi- nations	Kinetic Concepts, Inc. and Sub- sidiaries
ASSETS:					
Current assets:					
Cash and cash equivalents	\$ -	\$ -	\$ 5,301	\$ (5,102)	\$ 199
Accounts receivable, net	-	115,368	25,092	(19,096)	121,364
Inventories, net	-	22,432	17,734	-	40,166
Prepaid expenses and other current assets	-	4,550	4,787	-	9,337
Total current assets	-	142,350	52,914	(24,198)	171,066
Net property, plant and equipment	-	93,893	9,184	(13,096)	89,981
Loan issuance cost, net	-	8,602	-	-	8,602
Goodwill, net	-	39,381	3,654	-	43,035
Other assets, net	-	29,227	1,282	-	30,509
Intercompany investments and advances	(236,325)	500,348	24,291	(288,314)	-
	\$ (236,325)	\$ 813,801	\$ 91,325	\$(325,608)	\$ 343,193
LIABILITIES AND SHARE- HOLDERS' EQUITY (DEFICIT):					
Accounts payable	\$ -	\$ 10,213	\$ 3,318	\$ (5,102)	\$ 8,429
Accrued expenses	-	35,471	12,637	-	48,108
Current installments of long- term obligations	-	2,750	-	-	2,750
Intercompany payables	-	39,584	-	(39,584)	-
Current installments of capital lease obligations	-	171	-	-	171
Derivative financial instruments	-	2,512	-	-	2,512
Income taxes payable	-	7,227	1,534	-	8,761
Total current liabilities	-	97,928	17,489	(44,686)	70,731
Long-term obligations, net of current installments	-	503,875	-	-	503,875
Capital lease and other obligations, net of current installments	-	549	-	-	549
Deferred income taxes, net	-	15,186	-	(10,823)	4,363
Shareholders' equity (deficit)	(236,325)	196,263	73,836	(270,099)	(236,325)
	\$ (236,325)	\$ 813,801	\$ 91,325	\$(325,608)	\$ 343,193

**Condensed Consolidating Guarantor, Non-Guarantor And
Parent Company Statement of Earnings
For the three months ended June 30, 2002
(in thousands)
(unaudited)**

	<u>Kinetic Concepts, Inc. Parent Company Borrower</u>	<u>Guarantor Sub- sidiaries</u>	<u>Non- Guarantor Sub- sidiaries</u>	<u>Reclassi- fications and Elimi- nations</u>	<u>Historical Kinetic Concepts, Inc. and Sub- sidiaries</u>
REVENUE:					
Rental and service	\$ -	\$ 86,757	\$ 20,838	\$ -	\$ 107,595
Sales and other	-	25,068	10,456	(6,011)	29,513
Total revenue	-	111,825	31,294	(6,011)	137,108
Rental expenses	-	48,301	18,815	-	67,116
Cost of goods sold	-	11,736	3,950	(3,922)	11,764
	-	60,037	22,765	(3,922)	78,880
Gross profit	-	51,788	8,529	(2,089)	58,228
Selling, general and administrative expenses	-	29,093	2,987	-	32,080
Operating earnings	-	22,695	5,542	(2,089)	26,148
Interest income	-	19	80	-	99
Interest expense	-	(10,384)	-	-	(10,384)
Foreign currency gain (loss)	-	3,024	(32)	-	2,992
Earnings before income taxes and equity in earnings of subsidiaries	-	15,354	5,590	(2,089)	18,855
Income taxes	-	6,075	1,988	(804)	7,259
Earnings before equity in earnings of subsidiaries	-	9,279	3,602	(1,285)	11,596
Equity in earnings of subsidiaries	11,596	3,602	-	(15,198)	-
Net earnings	\$ 11,596	\$ 12,881	\$ 3,602	\$ (16,483)	\$ 11,596

**Condensed Consolidating Guarantor, Non-Guarantor And
Parent Company Statement of Earnings
For the three months ended June 30, 2001
(in thousands)
(unaudited)**

	<u>Kinetic Concepts, Inc. Parent Company Borrower</u>	<u>Guarantor Sub- sidiaries</u>	<u>Non- Guarantor Sub- sidiaries</u>	<u>Reclassi- fications and Elimi- nations</u>	<u>Historical Kinetic Concepts, Inc. and Sub- sidiaries</u>
REVENUE:					
Rental and service	\$ -	\$ 70,142	\$ 16,870	\$ -	\$ 87,012
Sales and other	-	17,795	6,390	(2,574)	21,611
Total revenue	-	87,937	23,260	(2,574)	108,623
Rental expenses	-	39,990	13,201	-	53,191
Cost of goods sold	-	7,283	1,835	(1,370)	7,748
	-	47,273	15,036	(1,370)	60,939
Gross profit	-	40,664	8,224	(1,204)	47,684
Selling, general and administrative expenses	-	25,241	1,688	-	26,929
Operating earnings	-	15,423	6,536	(1,204)	20,755
Interest income	-	130	20	-	150
Interest expense	-	(11,360)	-	-	(11,360)
Foreign currency loss	-	(275)	(46)	-	(321)
Earnings before income taxes and equity in earnings of subsidiaries	-	3,918	6,510	(1,204)	9,224
Income taxes	-	2,091	2,064	(281)	3,874
Earnings before equity in earnings of subsidiaries	-	1,827	4,446	(923)	5,350
Equity in earnings of subsidiaries	5,350	4,446	-	(9,796)	-
Net earnings	\$ 5,350	\$ 6,273	\$ 4,446	\$ (10,719)	\$ 5,350

**Condensed Consolidating Guarantor, Non-Guarantor And
Parent Company Statement of Earnings
For the six months ended June 30, 2002
(in thousands)
(unaudited)**

	<u>Kinetic Concepts, Inc. Parent Company Borrower</u>	<u>Guarantor Sub- sidiaries</u>	<u>Non- Guarantor Sub- sidiaries</u>	<u>Reclassi- fications and Elimi- nations</u>	<u>Historical Kinetic Concepts, Inc. and Sub- sidiaries</u>
REVENUE:					
Rental and service	\$ -	\$ 169,507	\$ 39,503	\$ -	\$ 209,010
Sales and other	-	46,687	19,738	(11,186)	55,239
Total revenue	-	216,194	59,241	(11,186)	264,249
Rental expenses	-	93,474	35,432	-	128,906
Cost of goods sold	-	21,399	7,034	(7,064)	21,369
	-	114,873	42,466	(7,064)	150,275
Gross profit	-	101,321	16,775	(4,122)	113,974
Selling, general and administrative expenses	-	57,613	5,659	-	63,272
Operating earnings	-	43,708	11,116	(4,122)	50,702
Interest income	-	21	88	-	109
Interest expense	-	(20,692)	-	-	(20,692)
Foreign currency gain (loss)	-	2,559	(111)	-	2,448
Earnings before income taxes and equity in earnings of subsidiaries	-	25,596	11,093	(4,122)	32,567
Income taxes	-	10,341	3,784	(1,587)	12,538
Earnings before equity in earnings of subsidiaries	-	15,255	7,309	(2,535)	20,029
Equity in earnings of subsidiaries	20,029	7,309	-	(27,338)	-
Net earnings	\$ 20,029	\$ 22,564	\$ 7,309	\$ (29,873)	\$ 20,029

**Condensed Consolidating Guarantor, Non-Guarantor And
Parent Company Statement of Earnings
For the six months ended June 30, 2001
(in thousands)
(unaudited)**

	<u>Kinetic Concepts, Inc. Parent Company Borrower</u>	<u>Guarantor Sub- sidiaries</u>	<u>Non- Guarantor Sub- sidiaries</u>	<u>Reclassi- fications and Elimi- nations</u>	<u>Historical Kinetic Concepts, Inc. and Sub- sidiaries</u>
REVENUE:					
Rental and service	\$ -	\$ 134,335	\$ 34,021	\$ -	\$ 168,356
Sales and other	-	34,437	13,401	(4,334)	43,504
Total revenue	-	168,772	47,422	(4,334)	211,860
Rental expenses	-	77,899	26,246	-	104,145
Cost of goods sold	-	14,743	4,438	(3,298)	15,883
	-	92,642	30,684	(3,298)	120,028
Gross profit	-	76,130	16,738	(1,036)	91,832
Selling, general and administrative expenses	-	47,434	3,386	-	50,820
Operating earnings	-	28,696	13,352	(1,036)	41,012
Interest income	-	145	45	-	190
Interest expense	-	(23,294)	-	-	(23,294)
Foreign currency gain (loss)	-	(1,248)	2	-	(1,246)
Earnings before income taxes and equity in earnings of subsidiaries	-	4,299	13,399	(1,036)	16,662
Income taxes	-	3,042	4,386	(430)	6,998
Earnings before equity in earnings of subsidiaries	-	1,257	9,013	(606)	9,664
Equity in earnings of subsidiaries	9,664	9,013	-	(18,677)	-
Net earnings	\$ 9,664	\$ 10,270	\$ 9,013	\$ (19,283)	\$ 9,664

**Condensed Consolidating Guarantor, Non-Guarantor And
Parent Company Statement of Cash Flows
For the six months ended June 30, 2002
(in thousands)
(unaudited)**

	Kinetic Concepts, Inc. Parent Company Borrower	Guarantor Sub- sidiaries	Non- Guarantor Sub- sidiaries	Reclassi- fications and Elimi- nations	Kinetic Concepts, Inc. and Sub- sidiaries
Cash flows from operating activities:					
Net earnings	\$ 20,029	\$ 22,564	\$ 7,309	\$ (29,873)	\$ 20,029
Adjustments to reconcile net earnings to net cash provided by operating activities	(20,029)	6,961	(3,864)	20,830	3,898
Net cash provided by operating activities	-	29,525	3,445	(9,043)	23,927
Cash flows from investing activities:					
Additions to property, plant and equipment	-	(19,694)	(11,815)	1,009	(30,500)
Decrease in inventory to be converted into equipment for short-term rental	-	1,100	-	-	1,100
Dispositions of property, plant and equipment	-	1,130	669	-	1,799
Businesses acquired in purchase transactions, net of cash acquired	-	-	(3,596)	-	(3,596)
Increase in other assets	-	(737)	(435)	-	(1,172)
Net cash used by investing activities	-	(18,201)	(15,177)	1,009	(32,369)
Cash flows from financing activities:					
Borrowings of notes payable, long-term, capital lease and other obligations	-	17,076	-	12	17,088
Proceeds from exercise of stock options	8	-	12	(12)	8
Proceeds (borrowings) on intercompany investments and advances	(5,691)	(21,698)	8,923	18,466	-
Other	5,683	(5,168)	5,330	(5,845)	-
Net cash provided (used) by financing activities	-	(9,790)	14,265	12,621	17,096
Effect of exchange rate changes on cash and cash equivalents	-	-	-	515	515
Net increase in cash and cash equivalents	-	1,534	2,533	5,102	9,169
Cash and cash equivalents, beginning of period	-	-	5,301	(5,102)	199
Cash and cash equivalents, end of period	\$ -	\$ 1,534	\$ 7,834	\$ -	\$ 9,368

**Condensed Consolidating Guarantor, Non-Guarantor And
Parent Company Statement of Cash Flows
For the six months ended June 30, 2001
(in thousands)
(unaudited)**

	Kinetic Concepts, Inc. Parent Company <u>Borrower</u>	Guarantor Sub- sidiaries	Non- Guarantor Sub- sidiaries	Reclassi- fications and Elimi- nations	Kinetic Concepts, Inc. and Sub- sidiaries
Cash flows from operating activities:					
Net earnings	\$ 9,664	\$ 10,270	\$ 9,013	\$ (19,283)	\$ 9,664
Adjustments to reconcile net earnings to net cash provided by operating activities	(9,664)	(6,781)	457	16,249	261
Net cash provided by operating activities	-	3,489	9,470	(3,034)	9,925
Cash flows from investing activities:					
Additions to property, plant and equipment	-	(16,625)	(3,895)	1,134	(19,386)
Increase in inventory to be converted into equipment for short-term rental	-	(700)	-	-	(700)
Dispositions of property, plant and equipment	-	288	693	-	981
Decrease (increase) in other assets	-	(2,258)	538	-	(1,720)
Net cash used by investing activities	-	(19,295)	(2,664)	1,134	(20,825)
Cash flows from financing activities:					
Borrowings of notes payable, long-term, capital lease and other obligations	-	11,505	-	-	11,505
Proceeds on intercompany investments and advances	1,058	3,767	204	(5,029)	-
Other	(1,058)	534	(5,870)	6,394	-
Net cash provided (used) by financing activities	-	15,806	(5,666)	1,365	11,505
Effect of exchange rate changes on cash and cash equivalents	-	-	-	(525)	(525)
Net increase in cash and cash equivalents	-	-	1,140	(1,060)	80
Cash and cash equivalents, beginning of period	-	-	6,156	(4,017)	2,139
Cash and cash equivalents, end of period	\$ -	\$ -	\$ 7,296	\$ (5,077)	\$ 2,219

FORWARD LOOKING STATEMENTS

This quarterly report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934. When used in this Report, the words "estimate," "project," "anticipate," "expect", "intend", "believe" and similar expressions are intended to identify forward-looking statements.

All of the forward-looking statements contained in this report are based on estimates and assumptions made by management of the Company. These estimates and assumptions reflect management's best judgment based on currently known market and other factors. Although management believes such estimates and assumptions to be reasonable, they are inherently uncertain and involve risks and uncertainties beyond the Company's control. In addition, management's assumptions about future events may prove to be inaccurate. Management cautions all readers that the forward-looking statements contained in this report are not guarantees of future performance and the Company cannot assure any reader that such statements will be realized. In all likelihood, actual results will differ from those contemplated by such forward-looking statements. Any such differences could result from a variety of factors, including the following:

- foreign and domestic economic and business conditions;
- industry and market capacity;
- demographic changes;
- existing government regulations and changes in or the failure to comply with government regulations;
- competition;
- the loss of any significant customers;
- the significant indebtedness retained by the Company;
- failure of new products and services to achieve market acceptance;
- liability resulting from litigation; and
- other factors discussed elsewhere in this document.

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

Results of Operations

Second Quarter of 2002 Compared to Second Quarter of 2001

The following table sets forth, for the periods indicated, the percentage relationship of each item to total revenue as well as the change in each line item as compared to the second quarter of the prior year (dollars in thousands):

	<u>Three Months Ended June 30,</u>			
	<u>Revenue Relationship</u>		<u>Variance</u>	
	<u>2002</u>	<u>2001</u>	<u>Increase (Decrease)</u>	
			<u>\$</u>	<u>Pct</u>
Revenue:				
Rental and service	78 %	80 %	\$ 20,583	24 %
Sales and other	22	20	7,902	37
Total revenue	100	100	28,485	26
Rental expenses	49	49	13,925	26
Cost of goods sold	9	7	4,016	52
Gross profit	42	44	10,544	22
Selling, general and administrative expenses	23	25	5,151	19
Operating earnings	19	19	5,393	26
Interest income	-	-	(51)	(34)
Interest expense	(8)	(10)	976	9
Foreign currency	2	-	3,313	nm
Earnings before income taxes	13	9	9,631	104
Income taxes	5	4	3,385	87
Net earnings	8 %	5 %	\$ 6,246	117 %

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The Company's revenue is divided between two primary operating segments, USA and International. The following table sets forth, for the periods indicated, the amount of revenue derived from each of these segments (dollars in thousands):

	Three months ended June 30,		Variance	
	<u>2002</u>	<u>2001</u>	<u>Percent</u>	
USA				
V.A.C.	\$ 61,062	\$ 37,747	62	%
Surfaces / Other	44,741	46,786	(4)	
Subtotal	<u>105,803</u>	<u>84,533</u>	25	
International				
V.A.C.	10,173	5,387	89	
Surfaces / Other	21,132	18,703	13	
Subtotal	<u>31,305</u>	<u>24,090</u>	30	
Total revenue	<u>\$ 137,108</u>	<u>\$ 108,623</u>	26	%

Total Revenue: Total revenue in the second quarter of 2002 was \$137.1 million, an increase of \$28.5 million, or 26.2%, from the prior-year period due to increased demand for the V.A.C. wound healing device. Rental revenue of \$107.6 million increased \$20.6 million, or 23.7%, from the second quarter of 2001 while sales revenue of \$29.5 million increased \$7.9 million, or 36.6%, compared to the same period one year ago.

Total domestic revenue for the second quarter of 2002 was \$105.8 million, up \$21.3 million, or 25.2%, from the prior-year quarter due to increased wound healing device revenue. Domestic rental revenue of \$86.8 million increased \$16.6 million, or 23.7%, due primarily to increased usage of the V.A.C. Domestic surface rentals declined \$1.9 million, or 4.8%, during the quarter due primarily to lower overall pricing. Average domestic surface units on-rent during the three-month period declined 1.2% as compared to the prior year. Average acute care surfaces rented during the period increased 4.1% compared to the prior year. However, average extended care surfaces rented during the period decreased 8.2% compared to the prior year and home care surface units declined 19.4% year to year.

Domestic sales revenue was \$19.0 million for the second quarter of 2002, an increase of \$4.7 million, or 32.3%, from the prior-year period. This increase was due to increased V.A.C. disposable sales which were partially offset by lower sales of vascular products. The V.A.C. growth was attributable to higher unit demand associated with increased rental activity during the period.

Revenue from the Company's international operating unit, net of foreign currency exchange rate fluctuations, increased \$7.2 million, or 30.0%, to \$31.3 million in the second quarter of 2002. Rental revenue of \$20.8 million, internationally, increased approximately \$4.0 million, or 23.5%, from the prior-year period while international sales revenue for the quarter of \$10.5 million increased approximately \$3.2 million, or 45.1%. The rental revenue increase reflects higher patient surface rental units in a majority of markets, growth in the V.A.C. product lines and favorable currency exchange fluctuations. Growth in demand for the period, primarily in overlays and the V.A.C., was partially offset by lower overall prices. The international sales increase was primarily due to increased V.A.C. demand and favorable currency exchange fluctuations. On a constant exchange basis, total international revenue increased \$6.2 million, or 25.4%, rental revenue increased \$3.3 million, or 19.4%, and sales revenue increased \$2.9 million, or 39.6%.

Worldwide V.A.C. revenue for the second quarter of 2002 was \$71.2 million, an increase of \$28.1 million, or 65.2%, from the prior-year quarter. Domestic V.A.C. revenue of \$61.1 million increased

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\$23.3 million, or 61.8%, in the current quarter while international V.A.C. revenue of approximately \$10.1 million grew \$4.8 million, or 88.8%, compared to the year-ago period.

Total revenue excluding V.A.C., i.e., revenue from surfaces and vascular devices, for the second quarter of 2002 was flat compared to the prior-year quarter. Domestic non-V.A.C. revenue of \$44.7 million was down \$2.0 million compared to the second quarter of 2001 due primarily to lower overall pricing in the acute care market, resulting from unfavorable product mix and the implementation of the new Novation contract, along with lower sales volumes in vascular and acute care surface products. International non-V.A.C. revenue of \$21.1 million was up \$2.4 million, or 13.0%, due primarily to higher rentals in Canada, Italy and France, along with higher sales in Austria and Australia.

Rental Expenses: Rental, or "field", expenses of \$67.1 million increased \$13.9 million, or 26.2%, from \$53.2 million in 2001. The second quarter field expense increase was due primarily to increased labor, marketing, parts, disposables and product licensing expenses directly associated with the growth in V.A.C. revenue which were partially offset by currency fluctuations. Field expenses for the 2002 quarter represented 62.4% of total rental revenue compared to 61.1% in the prior year. This relative increase is attributable to investments in the international sales force which has lowered short-term sales labor productivity.

Cost of Goods Sold: Cost of goods sold of \$11.8 million in the second quarter of 2002 increased approximately \$4.1 million, or 51.8%, from \$7.7 million in the prior-year period due to higher sales volumes particularly related to use of the V.A.C. Sales margins decreased to 60.1% in the second quarter of 2002 as compared to 64.1% in the prior year due, in part, to an increase in V.A.C. home placements covered by managed care and insurance. Managed care providers generally prefer an all-inclusive per diem rate which covers the cost of the rental and all disposables used. This per diem rate is booked as rental revenue and is not allocated between rentals and sales.

Gross Profit: Gross profit increased \$10.5 million, or 22.1%, to \$58.2 million in the second quarter of 2002 from \$47.7 million in the second quarter of the prior year due primarily to the year-to-year increase in rental revenue resulting from increased demand for the V.A.C. Gross profit margin in the second quarter of 2002 was 42.5%, down from 43.9% in the second quarter of 2001, due primarily to the international labor force investments mentioned previously combined with unfavorable manufacturing variances in this period.

Selling, General and Administrative Expenses: Selling, general and administrative expenses increased \$5.2 million, or 19.1%, to \$32.1 million in the second quarter of 2002 from \$26.9 million in the second quarter of 2001. This increase was due primarily to higher administrative labor costs, i.e., claims billing costs and consulting associated with the increased usage of the V.A.C. product line. In addition, incentive compensation, research and development expenses and engineering expenses were all higher in the current-year quarter when compared to the second quarter of 2001. Expenditures for research and development represented approximately 3.2% of the Company's total operating expenditures for the current quarter compared to 3.3% in the prior year. The current year also reflects an accounting change which requires that goodwill and indefinite-lived intangible assets no longer be amortized ratably over the estimated useful life of the asset. The effect of this change in the second quarter of 2002 was to lower goodwill amortization by approximately \$840,000 as compared to the prior year. (See Note 6 of Notes to Condensed Consolidated Financial Statements). On a comparable basis, as a percentage of total revenue, selling, general and administrative expenses were 23.4% in the second quarter of 2002 compared to 24.8% in the second quarter of 2001.

Operating Earnings: Operating earnings for the period increased approximately \$5.3 million, or 26.0%, to \$26.1 million compared to \$20.8 million in the prior-year quarter. The increase in operating earnings was directly attributable to the increase in revenue, partially offset by higher operating costs and expenses.

Interest Expense: Interest expense in the second quarter of 2002 was \$10.4 million compared to \$11.4 million in the prior-year quarter. The interest expense decrease was due to lower interest rates

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associated with the Company's Senior Credit Facilities obtained through fixed-rate interest contracts. (See Note 5 of Notes to Condensed Consolidated Financial Statements.)

Net Earnings: Net earnings for the second quarter of 2002 increased \$6.2 million, or 116.8%, from the prior-year period to \$11.6 million due to the increase in operating earnings discussed previously. Effective tax rates for the second quarter of 2002 and 2001 were 38.5% and 42.0%, respectively.

Results of Operations

First Six Months of 2002 Compared to First Six Months of 2001

The following table sets forth, for the periods indicated, the percentage relationship of each item to total revenue as well as the change in each line item as compared to the first six months of the prior year (dollars in thousands):

	<u>Six Months Ended June 30,</u>			
	<u>Revenue Relationship</u>		<u>Variance</u>	
	<u>2002</u>	<u>2001</u>	<u>Increase (Decrease)</u>	
			<u>\$</u>	<u>Pct</u>
Revenue:				
Rental and service	79 %	79 %	\$ 40,654	24 %
Sales and other	21	21	11,735	27
Total revenue	100	100	52,389	25
Rental expenses	49	49	24,761	24
Cost of goods sold	8	8	5,486	35
Gross profit	43	43	22,142	24
Selling, general and administrative expenses	24	24	12,452	25
Operating earnings	19	19	9,690	24
Interest income	-	-	(81)	(43)
Interest expense	(8)	(11)	2,602	11
Foreign currency	1	-	3,694	296
Earnings before income taxes	12	8	15,905	95
Income taxes	4	3	5,540	79
Net earnings	8 %	5 %	\$ 10,365	107 %

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The Company's revenue is divided between two primary operating segments, USA and International. The following table sets forth, for the periods indicated, the amount of revenue derived from each of these segments (dollars in thousands):

	Six months ended June 30,		Variance
	2002	2001	Percent
USA			
V.A.C.	\$ 115,516	\$ 68,810	68 %
Surfaces / Other	89,466	94,386	(5)
Subtotal	<u>204,982</u>	<u>163,196</u>	26
International			
V.A.C.	18,213	10,377	76
Surfaces / Other	41,054	38,287	7
Subtotal	<u>59,267</u>	<u>48,664</u>	22
Total revenue	<u>\$ 264,249</u>	<u>\$ 211,860</u>	25 %

Total Revenue: Total revenue in the first six months of 2002 was \$264.2 million, an increase of \$52.4 million, or 24.7%, from the prior-year period due to increased demand for the V.A.C. wound healing device. Rental revenue of \$209.0 million increased \$40.7 million, or 24.1%, from the first six months of 2001 while sales revenue of \$55.2 million increased \$11.7 million, or 27.0%, compared to the same period one year ago.

Total domestic revenue for the first half of 2002 was \$205.0 million, up \$41.8 million, or 25.6%, from the prior-year period due to increased wound healing device revenue. Domestic rental revenue of \$169.5 million increased \$35.2 million, or 26.2%, due primarily to increased usage of the V.A.C. Domestic surface rentals decreased \$3.1 million, or 4.0%, from the prior year due primarily to lower average pricing. Average domestic surface units on-rent for the first half of 2002 declined less than 1.0% as compared to the prior year. Average acute care surfaces increased 3.6% compared to the prior year. However, average extended care surfaces decreased by 4.9% compared to the prior period and home care surface rental units decreased 21.3%.

Domestic sales revenue was \$35.5 million for the first six months of 2002, an increase of \$6.6 million, or 22.9%, from the prior-year period. This increase was due to increased V.A.C. disposable sales which were partially offset by lower sales of vascular products. The V.A.C. growth was attributable to higher unit demand related to increased rental activity.

Revenue from the Company's international operating unit, net of foreign currency exchange rate fluctuations, increased \$10.6 million, or 21.8%, to approximately \$59.2 million in first half of 2002. International rental revenue of \$39.5 million increased \$5.5 million from 2001, or 16.1%, and sales revenue of approximately \$19.7 million for the first six months was up \$5.1 million, or 35.0%, compared to the prior year. The rental revenue increase reflects higher patient surface rental units in a majority of markets and growth in the V.A.C. product lines. Demand growth for the period, primarily in overlays and the V.A.C., was partially offset by lower overall prices. The international sales increase was primarily due to increased V.A.C. demand. On a constant exchange basis, total international revenue increased \$10.8 million, or 22.3%, rental revenue increased \$5.6 million, or 16.7%, and sales revenue increased \$5.2 million, or 35.2%.

Worldwide V.A.C. revenue for the first six months of 2002 was \$133.7 million, an increase of \$54.5 million, or 68.9%, from the prior-year period. Domestic V.A.C. revenue of \$115.5 million increased \$46.7 million, or 67.9%, in the current-year period while international V.A.C. revenue of \$18.2 million grew \$7.8 million, or 75.5%, compared to the prior-year period.

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Total revenue excluding V.A.C., i.e., revenue from surfaces and vascular devices, was \$130.5 million, a decrease of approximately \$2.1 million, or 1.6%, from the first half of 2001. Domestic non-V.A.C. revenue of \$89.5 million was down \$4.9 million, or 5.2%, compared to the first six months of 2001 due primarily to lower overall pricing in the acute care market, resulting from unfavorable product mix and the implementation of the new Novation contract, along with lower sales volumes in vascular and home care surface products. International non-V.A.C. revenue of approximately \$41.0 million was up \$2.8 million, or 7.2%, due primarily to higher rentals in Canada, Italy and Germany along with higher sales in the United Kingdom, Austria, Australia and Canada, partially offset by lower sales in Germany.

Rental Expenses: Rental, or "field", expenses of \$128.9 million increased \$24.8 million, or 23.8%, from \$104.1 million in the prior-year period. The field expense increase was due primarily to increased labor, marketing, parts, disposables and product licensing expenses directly associated with the growth in V.A.C. revenue which were partially offset by currency fluctuations. Field expenses for the first six months of 2002 represented 61.7% of total rental revenue compared to 61.9% in the first six months of 2001. This relative decrease is attributable to the increase in rental revenue described previously.

Cost of Goods Sold: Cost of goods sold of \$21.4 million in the first six months of 2002 increased \$5.5 million, or 34.5%, from \$15.9 million in the prior-year period due to higher sales volumes particularly related to use of the V.A.C. Sales margins decreased to 61.3% in the first six months of 2002 as compared to 63.5% in the prior-year period due, in part, to higher sales activity in the home care setting, a portion of which is reimbursed by managed care and private insurance organizations. Managed care providers generally prefer an all-inclusive per diem rate which covers the cost of the rental and all disposables used. This per diem rate is booked as rental revenue and is not allocated between rentals and sales.

Gross Profit: Gross profit increased approximately \$22.2 million, or 24.1%, to \$114.0 million in the first six months of 2002 from \$91.8 million in the first six months of the prior-year period due primarily to the year-to-year increase in rental revenue resulting from increased demand for the V.A.C. Gross profit margin in the first six months of 2002 was 43.1%, down slightly from 43.3% in the first six months of 2001 due primarily to lower margins internationally as the Company opens new markets and builds associated sales infrastructure.

Selling, General and Administrative Expenses: Selling, general and administrative expenses increased \$12.5 million, or 24.5%, to \$63.3 million in the first six months of 2002 from \$50.8 million in the first six months of 2001. This increase was due primarily to higher administrative labor costs, i.e., claims billing costs and consulting associated with the increased usage of the V.A.C. product line. In addition, incentive compensation, engineering, depreciation, research and development expenses and provisions for insurance expense were all higher in the current-year six month period when compared to the first six month period of 2001. Expenditures for research and development represented approximately 3.7% of the Company's total operating expenditures for the current six months compared to 2.8% in the prior year. The first six months of 2002 also reflect an accounting change which requires that goodwill and indefinite-lived intangible assets no longer be amortized ratably over the estimated useful life of the asset. The effect of this change in the first six months of 2002 was to lower goodwill amortization by \$1.7 million as compared to the first six months of the prior year. (See Note 6 of Notes to Condensed Consolidated Financial Statements). On a comparable basis, as a percentage of total revenue, selling, general and administrative expenses were 23.9% in the first six months of 2002 compared to 24.0% in the first six months of 2001.

Operating Earnings: Operating earnings for the period increased \$9.7 million, or 23.6%, to \$50.7 million compared to \$41.0 million in the prior-year period. The increase in operating earnings was directly attributable to the increase in revenue, largely offset by higher operating costs and expenses.

Interest Expense: Interest expense in the first six-month period of 2002 was \$20.7 million compared to \$23.3 million in the prior-year period. The interest expense decrease was due to lower

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interest rates associated with the Company's Senior Credit Facilities obtained through fixed-rate interest contracts. (See Note 5 of Notes to Condensed Consolidated Financial Statements.)

Net Earnings: Net earnings for the first six months of 2002 increased \$10.4 million, or 107.3%, from the prior-year period to \$20.0 million due to the increase in operating earnings discussed previously. Effective tax rates for the first six months of 2002 and 2001 were 38.5% and 42.0%, respectively.

Financial Condition

The change in revenue and expenses experienced by the Company during the first six months of 2002 and other factors resulted in changes to the Company's balance sheet as follows:

Net accounts receivable at June 30, 2002 increased \$17.1 million, or 14.1%, to \$138.5 million as compared to \$121.4 million at December 31, 2001. This increase is due primarily to higher overall revenue and an increase in V.A.C.-related receivables from third-party payers including Medicare, Insurance and Managed Care Organizations ("MCO's"). Gross domestic accounts receivable from third-party payers, including governmental and non-governmental entities, increased \$10.0 million, or 16.0%, compared to the prior year-end primarily due to the increase in billed but unpaid items. Gross domestic accounts receivable from acute and extended care facilities and homecare dealers were \$50.2 million at June 30, 2002, up approximately \$3.0 million, or 6.4%, from the prior year end. Gross international trade accounts receivable at June 30, 2002 were \$34.4 million, up \$8.5 million, or 32.6%, from the end of 2001. For further discussion of accounts receivable, see "Critical Accounting Policies".

Net property, plant and equipment at June 30, 2002 increased \$13.2 million, or 14.7%, to \$103.2 million as compared to \$90.0 million at December 31, 2001. This increase was due primarily to net capital expenditures of \$27.6 million, comprised mainly of rental assets and construction costs associated with a new, larger customer service facility, partially offset by depreciation expense.

Goodwill, net of accumulated amortization, was \$46.3 million at June 30, 2002, compared to \$43.0 million at December 31, 2001. This increase relates to the acquisition of Polymedics by the Company in the first quarter of 2002. Goodwill represented 12.0% and 12.5% of total assets at June 30, 2002 and December 31, 2001, respectively. For further discussion of goodwill, see Note 6 of Notes to Condensed Consolidated Financial Statements and "Critical Accounting Policies".

Accrued expenses at June 30, 2002 were \$43.5 million compared to \$48.1 million at December 31, 2001. This decrease was due to bonus payments and reductions in vacation accruals during 2002 partially offset by accruals related to V.A.C. product licensing fees.

As of June 30, 2002, a liability of \$1.8 million related to a derivative financial instrument was recorded as a result of the adoption of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*. This liability was established based upon a valuation of the Company's interest rate protection agreement associated with its Senior Credit Facilities. (See Notes 5 and 11 of Notes to Condensed Consolidated Financial Statements.)

Income taxes payable at June 30, 2002 of \$16.8 million increased approximately \$8.0 million, as compared to \$8.8 million at December 31, 2001. This increase was due primarily to the current-period earnings level.

Long-term debt obligations, including current maturities, increased \$16.8 million to \$523.4 million as of June 30, 2002 due primarily to borrowings on the senior credit facility to fund working capital investments and capital expenditures, partially offset by scheduled amortization payments.

Net deferred income taxes at June 30, 2002 of \$3.5 million decreased 19.6% as compared to \$4.4 million at December 31, 2001. This decrease was due to the realization of temporary tax timing differences.

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Accumulated other comprehensive loss at June 30, 2002 was \$6.3 million as compared to \$10.0 million at December 31, 2001. This decrease was due to a decrease in the foreign exchange translation due to the weakened dollar.

The Company has not used any off-balance sheet arrangements other than the investments in non-recourse leveraged leases and its debt agreements contain no credit rating triggers.

Liquidity and Capital Resources

General

The Company's principal capital requirements consist of capital expenditures, primarily for rental assets and systems infrastructure, debt service requirements and working capital. The working capital is required principally to finance accounts receivable and inventory. The Company's working capital requirements vary from period to period depending on production volumes, the timing of shipments and the payment cycles of various customers and payers.

Sources of Capital

During the next twelve months, the Company's principal sources of liquidity are expected to be cash flows from operating activities and borrowings under the Senior Credit Facilities. Based upon the current level of operations, the Company anticipates that cash flow from operations and the availability under its Revolving Credit Facility will be adequate to meet its anticipated cash requirements for debt repayments, working capital and capital expenditures through 2003.

Due to the anticipated dramatic growth in V.A.C. demand during this period, slower payment cycles from certain payers and the increased capital expenditures and working capital required to support and maintain such growth, the Company's ability to generate cash flow sufficient to meet its 2004 debt amortization requirements may be at risk and therefore, the Company may need to increase borrowing or refinance its debt in future periods.

The Company's primary sources of capital have been funds from operations and its Senior Credit Facilities. At June 30, 2002, cash and cash equivalents of \$9.4 million were available for general corporate purposes. Availability under the revolving credit facility at June 30, 2002 was \$44.5 million. Also at June 30, 2002, the Company was committed to purchase approximately \$7.7 million of inventory associated with new products during the next twelve months. The Company did not have any other material purchase commitments.

Subsequent to June 30, 2002, the Company also completed the sale and leaseback of its corporate headquarters building, which resulted in net sale proceeds received of \$18.2 million.

Working Capital

At June 30, 2002, the Company had current assets of \$199.3 million and current liabilities of \$84.9 million resulting in a working capital surplus of approximately \$114.4 million, compared to a surplus of \$100.3 million at December 31, 2001. An increase in accounts receivable accounted for the majority of this change. Operating cash flows were \$23.9 million for the first six months of 2002 compared to \$9.9 million in the prior-year period. This increase was due to higher earnings and lower working capital requirements, primarily inventory associated with the V.A.C. product line and payables.

Capital Expenditures

During the first six months of 2002, the Company made net capital expenditures of \$27.6 million compared to \$19.1 million the prior-year period. The majority of this increase was due to purchases of materials for the V.A.C. and other high-demand rental products as well as expenditures related to the build-out of the Company's newly-leased customer service facility and purchases of computer

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hardware and software. Over the next twelve months, the Company also has commitments to purchase new product inventory, including disposable "for sale" products of \$7.7 million. Other than commitments for new product inventory, the Company has no material long-term capital commitments and can adjust the level of capital expenditures as circumstances warrant. The Company expects future demand for medical devices and associated disposables to increase.

Debt Service

Scheduled principal payments under the Company's Senior Credit Facilities as of April 2002 are \$3.0 million, \$30.6 million and \$86.8 million for the years 2002, 2003 and 2004, respectively. Based upon the current level of operations, the Company anticipates that cash flow from operations and the availability under its Revolving Credit Facility will be adequate to meet its anticipated cash requirements for debt repayments, working capital and capital expenditures through 2003. Due to the anticipated dramatic growth in V.A.C. demand during this period, slower payment cycles from certain payers and the increased capital expenditures and working capital required to support and maintain such growth, the Company's ability to generate cash flow sufficient to meet its 2004 debt amortization requirements may be at risk and therefore, the Company may need to increase borrowing or refinance its debt in future periods. The availability of such funding cannot be assured. Such additional borrowings would increase the Company's required payments to service debt and could negatively impact the Company's earnings and overall cash position. To address this issue, the Company is reviewing its order entry, billing and collection processes to reduce costs, shorten payment cycles and maximize cash flows.

The Senior Credit Facilities originally totaled \$400.0 million and consisted of (i) a \$50.0 million six-year Revolving Credit Facility, (ii) a \$50.0 million six-year Acquisition Facility, (iii) a \$120.0 million six-year amortizing Term Loan A, (iv) a \$90.0 million seven-year amortizing Term Loan B and (v) a \$90.0 million eight-year amortizing Term Loan C (collectively, the "Term Loans"). On June 15, 2001, the Company entered into an Amended and Restated Credit and Guarantee Agreement, which funded a \$95 million Tranche D Term Loan as part of a refinancing of the Company's Senior Secured Credit Facilities. Proceeds from the Tranche D Term Loan were used to pay down existing indebtedness, including \$60 million outstanding under the Tranche A Term Loan, approximately \$8 million outstanding under the Acquisition Credit Facility and \$26 million under the Revolving Credit Facility with the remaining proceeds used to pay fees and expenses associated with this transaction. The Revolving Loans may be repaid and reborrowed.

On April 4, 2002, the Company entered into a Second Amended and Restated Credit and Guarantee Agreement (the "Amended Credit Agreement"). The Amended Credit Agreement funded a \$30 million Tranche E Term Loan as part of a refinancing of the Company's Senior Secured Credit Facilities. Proceeds from the Tranche E Term Loan were used to pay down existing indebtedness of \$29.6 million under the Revolving Credit Facility with the remaining proceeds used to pay fees and expenses associated with the transaction. The Tranche E Term Loan will initially bear interest at a rate based upon the Base Rate plus 2.25%, or at the Company's option, the Eurodollar Rate plus 3.25%. In addition, performance-based reductions of the interest rate under Term Loan E are available. The Tranche E Term Loan amortizes at 1% per year beginning June 30, 2002 with a final payment of \$29.0 million due December 31, 2005.

At June 30, 2002, there were no borrowings under the Revolving Credit Facility. The Company may borrow additional funds under the Revolving Credit Facility at any time up to the borrowing limits thereunder. Three Letters of Credit in the aggregate amount of \$5.5 million were issued and outstanding at the request of the Company under the Revolving Credit Facility. Accordingly, as of June 30, 2002, the aggregate availability under the Revolving Credit Facility was \$44.5 million.

Indebtedness under the Senior Credit Facilities, as amended and restated, including the Revolving Credit Facility (other than certain loans under the Revolving Credit Facility designated in foreign currency) and the Term Loans, initially bear interest at a rate based upon (i) the Base Rate (defined as the higher of (x) the rate of interest publicly announced by Bank of America as its "reference rate" or (y) the federal funds effective rate from time to time plus 0.50%), plus 1.75% in respect of the

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Tranche A Term Loans and the loans under the Revolving Credit Facility (the "Revolving Loans"), 2.00% in respect of the Tranche B Term Loans, 2.25% in respect of the Tranche C and Tranche E Term Loans and 2.125% in respect of the Tranche D Term Loans, or at the Company's option, (ii) the Eurodollar Rate (as defined in the Senior Credit Facility Agreement) for one, two, three or six months, in each case plus 2.75% in respect of Tranche A Term Loans and Revolving Loans, 3.00% in respect of Tranche B Term Loans, 3.25% in respect of the Tranche C and Tranche E Term Loans and 3.125% in respect to the Tranche D Term Loans. Certain Revolving Loans designated in foreign currency will initially bear interest at a rate based upon the cost of funds for such loans plus 2.75%. Performance-based reductions of the interest rates under the Term Loans and the Revolving Loans are available.

In January 2001, the Company entered into an interest rate swap which fixed the base-borrowing rate on \$150 million of the Company's variable rate debt at 5.36% and was effective from January 5, 2001 through December 31, 2001. On October 1, 2001, the Company terminated its \$150 million, 5.36% interest rate swap to take advantage of lower interest rates and entered into two new interest rate swaps, which resulted in additional interest expense of \$1.1 million in the fourth quarter of 2001. One interest rate swap fixes the base-borrowing rate on \$150 million of the Company's variable rate debt at 3.57% per annum and is effective October 1, 2001 through December 31, 2002. The second interest rate swap fixes the rate on an additional \$100 million of the Company's variable rate debt at 2.99% annually and is effective October 1, 2001 through December 31, 2002. As of June 30, 2002, these agreements effectively fix the base-borrowing rate on 77.3% of the Company's variable rate debt. As a result of the interest rate protection agreements, the Company recorded additional interest expense of approximately \$740,000 and \$96,000 in the first six months of 2002 and 2001, respectively.

Indebtedness of the Company under the Senior Credit Facilities Agreement is guaranteed by certain of the subsidiaries of the Company and is secured by (i) a first priority security interest in all of the tangible and intangible assets of the Company and its domestic subsidiaries (subject to certain customary exceptions), including, without limitation, intellectual property and real estate owned by the Company and its subsidiaries, (ii) a first priority perfected pledge of all capital stock of the Company's domestic subsidiaries and (iii) a first priority perfected pledge of up to 65% of the capital stock of foreign subsidiaries owned directly by the Company or its domestic subsidiaries.

The Senior Credit Agreement requires the Company to meet certain financial tests, including minimum levels of EBITDA (as defined therein), minimum interest coverage, maximum leverage ratio and capital expenditures. The Senior Credit Agreement also contains covenants which, among other things, limit the Company's ability to: incur additional indebtedness, make investments, announce or pay dividends, make loans and advances, make capital expenditures, enter into transactions with affiliates, dispose of its assets, enter into acquisitions, mergers or consolidation transactions, make prepayments on other indebtedness, create or permit to be created any liens on any of its properties, or undertake certain other matters customarily restricted in such agreements. At June 30, 2002, the Company is in compliance with all applicable covenants.

The Senior Credit Agreement also contains customary events of default, including payment defaults, any breach of representations and warranties, covenant defaults, cross-defaults to certain other indebtedness, certain events of bankruptcy and insolvency, failures under ERISA plans, judgment defaults, any change of control of the Company and failure of any guaranty, security document, security interest or subordination provision under the Senior Credit Agreement. In addition, the Senior Credit Agreement provides for mandatory repayments, subject to certain exceptions, of the Term Loans and the Revolving Credit Facility based on certain net asset sales outside the ordinary course of business of the Company and its subsidiaries, the net proceeds of certain debt and equity issuances and excess cash flows.

As part of the 1997 Recapitalization transactions, the Company issued \$200.0 million of 9 5/8% Senior Subordinated Notes (the "Notes") due 2007. The Notes are unsecured obligations of the Company, ranking subordinate in right of payment to all senior debt of the Company and will mature on November 1, 2007. As of June 30, 2002, the entire \$200.0 million of Senior Subordinated Notes was issued and outstanding. The Notes are not entitled to the benefit of any mandatory sinking

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fund. The Notes will be redeemable, at the Company's option, in whole at any time or in part from time to time, on and after November 1, 2002, upon not less than 30 nor more than 60 days' notice, at the following redemption prices (expressed as percentages of the principal amount thereof) if redeemed during the twelve-month period commencing on November 1 of the year set forth below, plus, in each case, accrued and unpaid interest thereon, if any, to the date of redemption.

<u>Year</u>	<u>Percentage</u>
2002	104.813%
2003	103.208%
2004	101.604%
2005 and thereafter	100.000%

At any time, or from time to time, the Company may acquire a portion of the Notes through open-market purchases. In order to effect the foregoing redemption with the proceeds of any equity offering, the Company shall make such redemption not more than 120 days after the consummation of any such equity offering.

Known Trends or Uncertainties

The health care industry continues to face various challenges, including increased pressure on health care providers to control costs as a result of the ongoing implementation of the Balanced Budget Act of 1997 and related legislation, the accelerating migration of patients from acute care facilities into extended care (e.g., skilled nursing facilities and rehabilitation centers) and home care settings, the consolidation of health care providers and national and regional group purchasing organizations and the growing demand for clinically proven therapies which lower the total cost of providing care.

Reimbursement

The Company currently rents and sells the V.A.C. in all care settings and market acceptance of this product has been better than expected. This is evidenced by the significant revenue growth experienced in the six years that the product has been available domestically. Effective October 1, 2000, the Company received Medicare Part B reimbursement codes, an associated coverage policy and allowable rates for the V.A.C. and V.A.C. disposables in the home care setting. As a result of this coverage, the Company began to place V.A.C. units with Medicare-eligible patients in the home during the fourth quarter of 2000. Although it is difficult to predict the impact which Medicare pricing will have on other payers, the Company does not believe that the new rates will have a material adverse impact on the Company's business.

Euro Currency

On January 1, 1999, the European Economic and Monetary Union ("EMU") entered a three-year transition period during which a new common currency, the "Euro", was introduced in participating countries and fixed conversion rates were established through the European Central Bank ("ECB") between existing local currencies and the Euro. The Euro has traded on currency exchanges since that time. Until December 31, 2001, local currencies remained legal tender. During the transition period, goods and services could be paid for with the Euro or local currency under the EMU's "no compulsion, no prohibition" principle. Effective January 1, 2002, the Euro became the new legal tender.

Based on its evaluation to date, management believes that the introduction of the Euro will not have a long-term material adverse impact on the Company's financial position, results of operations or cash flows. However, the prevailing exchange rate for the Euro versus the U.S. dollar has, until the first half of 2002, declined and uncertainty exists as to the long-term effects the Euro will have in the marketplace.

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The Company anticipates the Euro will simplify financial issues related to cross-border trade in the EMU and reduce the transaction costs and administrative time necessary to manage this trade and related risks. However, the Company believes that the associated savings will not be material to corporate results.

Critical Accounting Policies

Accounts Receivable

The Company utilizes a combination of factors in evaluating the collectibility of accounts receivable. For unbilled receivables, items that remain unbilled for more than 90 days, or beyond required billing windows, are reversed out of revenue and receivables. For billed receivables, the Company generally recognizes reserves for bad debt based on the length of time that the receivables are past due. The reserves range in value from 0% for current amounts to 100% for amounts over 180 days past due for certain payer groups. The reserve rates vary by payer group and the Company's historical experience on a weighted average basis. In addition, the Company has recorded specific reserves for bad debt when it becomes aware of a customer's inability to satisfy its debt obligations e.g., bankruptcy filings. If circumstances change (i.e., higher than expected denials, payment defaults or an unexpected material adverse change in a major customer's or payer's ability to meet its obligations), the Company's estimates of the realizability of amounts due from trade receivables could be reduced by a material amount.

Goodwill And Other Intangible Assets

At June 30, 2002, goodwill, net of accumulated amortization, was \$46.3 million, as compared to \$43.0 million at December 31, 2001. This increase relates to the acquisition of Polymedics by the Company in the first quarter of 2002. Goodwill represented 12.0% and 12.5%, of total assets, at June 30, 2002 and December 31, 2001, respectively. Goodwill represents the excess purchase price over the fair value of net assets acquired. Effective January 1, 2002, the Company applied the provisions of Statement of Financial Accounting Standards No. 142 ("SFAS 142"), *Goodwill and Other Intangible Assets* in its accounting for goodwill. Under SFAS 142, goodwill and intangible assets that have indefinite useful lives are no longer subject to amortization over their estimated useful life. Rather, goodwill and intangible assets that have indefinite useful lives are and will be tested at least annually for impairment. SFAS 142 provides specific guidance for testing goodwill for impairment. Intangible assets with finite useful lives will continue to be amortized over their useful lives. Goodwill has been tested for impairment during the first quarter of 2002 and will be tested for impairment at least annually using the prescribed two-step process. The first step is an impairment screening which compares an estimation of the fair value of a reporting unit with the reporting unit's carrying value. The Company has determined that its reporting units are to be defined as the two operating segments - USA and International. If the fair value of a reporting unit exceeds its carrying amount, the goodwill of the reporting unit is not considered impaired, and as a result, the second step of the impairment test is not required. If required, the second step compares the fair value of reporting unit goodwill with the carrying amount of that goodwill. If the Company determines that reporting unit goodwill is impaired, the fair value of reporting unit goodwill would be measured by comparing the discounted expected future cash flows of the reporting unit with the carrying value of reporting unit goodwill. Any excess in the carrying value of reporting unit goodwill to the estimated fair value would be recognized in expense at the time of the recognition.

The goodwill of a reporting unit will be tested between the annual test if an event occurs or circumstances change that would likely reduce the fair value of a reporting unit below its carrying amount. Examples of such events or circumstances include, but are not limited to: a significant adverse change in legal factors or business climate, an adverse regulatory action or unanticipated competition.

Inventory

The Company reviews its inventory balances monthly for excess and/or obsolete inventory levels. For products that are not rented, i.e., sales products, except where firm orders are on-hand, inventory quantities in excess of the last twelve months demand are considered excess and are reserved at 50% of cost. For rental products, the Company reviews both product usage and product life cycle to classify inventory as active, discontinued or obsolete. Obsolescence reserve balances are established on an increasing basis from 0% for active, high-demand products to 100% for obsolete products. In addition, judgmental reserve balances are established for "high risk" items, for example, products that have a fixed shelf life as determined by the manufacturer.

Legal Proceedings

On February 21, 1992, Novamedix Limited ("Novamedix") filed a lawsuit against the Company in the United States District Court for the Western District of Texas. Novamedix manufactures the principal product which directly competes with the PlexiPulse. The suit alleges that the PlexiPulse infringes several patents held by Novamedix, that the Company breached a confidential relationship with Novamedix and a variety of ancillary claims. Novamedix seeks injunctive relief and monetary damages. A judicial stay is in effect with respect to all patent claims in this case. Although it is not possible to reliably predict the outcome of this litigation or the damages which could be awarded, the Company believes that its defenses to these claims are meritorious and that the litigation will not have a material adverse effect on the Company's business, financial condition or results of operations.

On August 16, 1995, the Company filed a civil antitrust lawsuit against Hillenbrand Industries, Inc. and one of its subsidiaries, Hill-Rom. The suit was filed in the United States District Court for the Western District of Texas. The suit alleges that Hill-Rom used its monopoly power in the standard hospital bed business to gain an unfair advantage in the specialty hospital bed business. Specifically, the allegations set forth in the suit include a claim that Hill-Rom required hospitals and purchasing groups to agree to exclusively rent specialty beds in order to receive substantial discounts on products over which they have monopoly power - hospital beds and head wall units. Hill-Rom has filed an answer denying the allegations in the suit. Discovery is complete and the trial has been scheduled for August 2002. Although it is not possible to reliably predict the outcome of this litigation or the damages which might be awarded, the Company believes that its claims are meritorious.

On October 31, 1996, the Company received a counterclaim which had been filed by Hillenbrand Industries, Inc. in the antitrust lawsuit which the Company filed in 1995. The counterclaim alleges that the Company's antitrust lawsuit and other actions were designed to enable KCI to monopolize the specialty therapeutic surface market. Although it is not possible to reliably predict the outcome of this litigation, the Company believes that the counterclaim is without merit.

On January 7, 1998, Mondomed N.V. filed an opposition in the European Patent Office (the "Opposition") to a European patent covering the V.A.C. owned by Wake Forest University and licensed by the Company. They were joined in this Opposition by Paul Hartmann A.G. on December 16, 1998. On February 13, 2002, the Opposition Division of the European Patent Office issued a non-binding Preliminary Opinion in favor of the Company. The parties are permitted to respond to the Preliminary Opinion and a hearing will be held prior to the issuance of a Final Opinion. Although it is not possible to reliably predict the outcome of the Opposition, the Company believes that the Opposition is without merit.

The Company is a party to several lawsuits arising in the ordinary course of its business. Provisions have been made in the Company's financial statements for estimated exposures related to these lawsuits. In the opinion of management, the disposition of these matters will not have a material adverse effect on the Company's business, financial condition or results of operations.

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The manufacturing and marketing of medical products necessarily entails an inherent risk of product liability claims. The Company currently has certain product liability claims pending for which provision has been made in the Company's financial statements. Management believes that resolution of these claims will not have a material adverse effect on the Company's business, financial condition or results of operations. The Company has not experienced any significant losses due to product liability claims and management believes that the Company currently maintains adequate liability insurance coverage.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to various market risks, including fluctuations in interest rates and variability in currency exchange rates. The Company has established policies, procedures and internal processes governing its management of market risks and the use of financial instruments to manage its exposure to such risks.

Interest Rate Risk

On October 1, 2001, the Company terminated its \$150 million, 5.36% interest rate swap to take advantage of lower interest rates and entered into two new interest rate swaps, which resulted in additional interest expense of \$1.1 million in the fourth quarter of 2001. One interest rate swap fixes the base-borrowing rate on \$150 million of the Company's variable rate debt at 3.57% per annum and is effective October 1, 2001 through December 31, 2002. The second interest rate swap fixes the rate on an additional \$100 million of the Company's variable rate debt at 2.99% annually and is effective October 1, 2001 through December 31, 2002. As of June 30, 2002, these agreements effectively fix the base-borrowing rate on 77.3% of the Company's variable rate debt. As a result of the interest rate protection agreements, the Company believes that movements in short term interest rates will not materially affect the financial position of the Company for the remainder of the year.

Foreign Currency And Market Risk

The Company has direct operations in Western Europe, Canada and Australia and distributor relationships in many other parts of the world. The Company's foreign operations are measured in their applicable local currencies. As a result, the Company's financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in the foreign markets in which the Company has operations. Exposure to these fluctuations is managed primarily through the use of natural hedges, whereby funding obligations and assets are both managed in the applicable local currency.

The Company maintains no other derivative instruments to mitigate its exposure to translation and/or transaction risk. International operations reported operating profit of \$8.8 million for the first six months of 2002. It is estimated that a 10% fluctuation in the value of the dollar relative to these foreign currencies at June 30, 2002 would change the Company's net income for the first six months of 2002 by approximately \$680,000. The Company's analysis does not consider the implications that such fluctuations could have on the overall economic activity that could exist in such an environment in the U.S. or the foreign countries or on the results of operations of these foreign entities.

PART II - OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS

A list of all exhibits filed or included as part of this quarterly report on Form 10-Q is as follows:

<u>Exhibit</u>	<u>Description</u>
3.1	Restatement of Articles of Incorporation (filed as Exhibit 3.2 to the Company's Registration Statement on Form S-1, as amended (Registration No. 33-21353), and incorporated herein by reference).
3.2	Restated By-Laws of the Company (filed as Exhibit 3.3 to the Company's Registration Statement on Form S-1, as amended (Registration No. 33-21353), and incorporated herein by reference).
4.1	Specimen Common Stock Certificate of the Company (filed as Exhibit 4.1 to the Annual Report on Form 10-K for the year ended December 31, 1988, and incorporated herein by reference).
10.1	KCI Employee Benefits Trust Agreement (filed as Exhibit 10.21 to the Company's Annual Report on Form 10-K/A dated December 31, 1994, and incorporated herein by reference).
10.2	Letter, dated November 22, 1994, from the Company to Christopher M. Fashek outlining the terms of his employment (filed as Exhibit 10.23 to the Company's Annual Report on Form 10-K/A dated December 31, 1994, and incorporated herein by reference).
10.3	Deferred Compensation Plan (filed as Exhibit 99.2 to the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 1995 and incorporated herein by reference).
10.4	Kinetic Concepts, Inc. Senior Executive Stock Option Plan (filed as Exhibit 10.31 to the Company's Annual Report on Form 10-K for the year ended December 31, 1996, and incorporated herein by reference).
10.5	Form of Option Instrument with respect to Senior Executive Stock Option Plan (filed as Exhibit 10.32 to the Company's Annual Report on Form 10-K for the year ended December 31, 1996, and incorporated herein by reference).
10.6	Kinetic Concepts Management Equity Plan effective October 1, 1997 (filed as Exhibit 10.33 on Form 10-K for the year ended December 31, 1997, and incorporated herein by reference).
10.7	Director Equity Agreement, dated May 12, 1998, between the Company and Charles N. Martin (filed as Exhibit 10.8 on Form 10-K for the year ended December 31, 1998, and incorporated herein by reference).
10.8	Letter, dated June 4, 1998, from the Company to William M. Brown outlining the terms of his employment (filed as Exhibit 10.10 on Form 10-K for the year ended December 31, 1998, and incorporated herein by reference).

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Exhibits (continued)

- 10.9 Supplier Agreement, dated December 1, 1998, between Novation, LLC and Kinetic Concepts, Inc. (filed as Exhibit 10.11 on Form 10-K for the year ended December 31, 1998, and incorporated herein by reference).
- 10.10 Letter, dated March 28, 2000, from the Company to Dennert O. Ware outlining the terms of his employment (filed as Exhibit 10.12 on Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference).
- 10.11 Third Amendment to the Credit and Guarantee Agreement dated as of February 24, 2000 by and among the Company, several banks and financial institutions, as Lenders, Bank of America, as administrative agent and Bankers Trust Company, as syndication agent (filed as Exhibit 10.13 on Form 10-Q for the quarter ended March 31, 2000, and incorporated herein by reference).
- 10.12 Kinetic Concepts, Inc. CEO Special Bonus Plan (filed as Exhibit 10.12 on Form 10-K for the year ended December 31, 2000, and incorporated herein by reference).
- 10.13 Kinetic Concepts, Inc. 2000 Special Bonus Plan (filed as Exhibit 10.13 on Form 10-K for the year ended December 31, 2000, and incorporated herein by reference).
- 10.14 Form of Option Instrument with Respect to the Kinetic Concepts, Inc. Management Equity Plan (filed as Exhibit 10.14 on Form 10-K for the year ended December 31, 2000, and incorporated herein by reference).
- 10.15 Amended and Restated Credit and Guarantee Agreement dated as of June 15, 2001 by and among the Company, several banks and financial institutions, as Lenders, Bank of America, ad administrative agent and Bankers Trust Company, as syndication agent (filed as Exhibit 10.15 on Form 10-Q for the quarter ended June 30, 2001, and incorporated herein by reference).
- 10.16 Supplier Agreement, dated September 1, 2001, between Novation, LLC and KCI USA, Inc. (filed as Exhibit 10.16 on Form 10-Q for the quarter ended September 30, 2001, and incorporated herein by reference).
- 10.17 Second Amended and Restated Credit and Guarantee Agreement dated as of April 4, 2002 by and among the Company, several banks and financial institutions, as Lenders, Bank of America, as administrative agent and Bankers Trust Company, as syndication agent (filed as Exhibit 10.17 on Form 10-Q for the quarter ended March 31, 2002, and incorporated herein by reference).
- 21.1 List of Subsidiaries (filed as Exhibit 21.1 to the Company's Annual Report on Form 10-K for the year ended December 31, 2001, and incorporated herein by reference).
- *99.1 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 dated as of August 13, 2002.

Note: (*) Exhibits filed herewith.

(b) REPORTS ON FORM 8-K

No reports on Form 8-K have been filed during the quarter for which this report is filed.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KINETIC CONCEPTS, INC.
(REGISTRANT)

By: /s/ DENNERT O. WARE

Dennert O. Ware
President and Chief Executive Officer

By: /s/ WILLIAM M. BROWN

William M. Brown
Vice President and Chief Financial Officer

Date: August 13, 2002