

STERIS CORP
Form 10-Q
October 30, 2015
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q
(Mark One)

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

x

For the quarterly period ended September 30, 2015

or

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

o

For the transition period from _____ to _____

Commission File Number 1-14643

STERIS Corporation
(Exact name of registrant as specified in its charter)

Ohio
(State or other jurisdiction of
incorporation or organization)

34-1482024
(IRS Employer
Identification No.)

5960 Heisley Road,
Mentor, Ohio
(Address of principal executive offices)
440-354-2600

44060-1834
(Zip code)

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Smaller Reporting Company

(Do not check if a smaller reporting company)

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of common shares outstanding as of October 23, 2015: 59,955,983

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PART I— FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STERIS CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands)

	September 30, 2015 (Unaudited)	March 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 162,187	\$ 167,689
Accounts receivable (net of allowances of \$11,035 and \$9,415, respectively)	301,390	325,289
Inventories, net	183,951	160,818
Deferred income taxes, net	29,140	31,629
Prepaid expenses and other current assets	36,340	35,007
Total current assets	713,008	720,432
Property, plant, and equipment, net	505,355	493,053
Goodwill and intangibles, net	1,075,028	860,645
Other assets	15,687	23,161
Total assets	\$2,309,078	\$2,097,291
Liabilities and equity		
Current liabilities:		
Accounts payable	\$84,083	\$99,340
Accrued income taxes	349	7,154
Accrued payroll and other related liabilities	52,177	74,805
Accrued expenses and other	120,878	102,032
Total current liabilities	257,487	283,331
Long-term indebtedness	829,818	621,075
Deferred income taxes, net	77,146	71,905
Other liabilities	52,836	47,334
Total liabilities	\$1,217,287	\$1,023,645
Commitments and contingencies (see note 9)		
Serial preferred shares, without par value; 3,000 shares authorized; no shares issued or outstanding	—	—
Common shares, without par value; 300,000 shares authorized; 70,040 shares issued; 59,914 and 59,675 shares outstanding, respectively	272,200	264,853
Common shares held in treasury, 10,126 and 10,364 shares, respectively	(319,802	) (320,343
Retained earnings	1,198,030	1,193,791
Accumulated other comprehensive income	(59,463	) (66,669
Total shareholders' equity	1,090,965	1,071,632
Noncontrolling interest	826	2,014
Total equity	1,091,791	1,073,646
Total liabilities and equity	\$2,309,078	\$2,097,291

See notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2015	2014	2015	2014
Revenues:				
Product	\$274,145	\$256,845	\$506,452	\$487,285
Service	215,752	205,884	423,347	388,087
Total revenues	489,897	462,729	929,799	875,372
Cost of revenues:				
Product	148,088	142,991	277,944	272,966
Service	132,488	125,746	258,444	238,321
Total cost of revenues	280,576	268,737	536,388	511,287
Gross profit	209,321	193,992	393,411	364,085
Operating expenses:				
Selling, general, and administrative	172,459	126,292	299,294	239,980
Research and development	14,255	13,006	28,020	25,415
Restructuring expenses	(56	) 1,271	(782	) 1,099
Total operating expenses	186,658	140,569	326,532	266,494
Income from operations	22,663	53,423	66,879	97,591
Non-operating expenses, net:				
Interest expense	7,485	4,948	13,605	9,630
Interest income and miscellaneous expense	(663	) (36	) (1,125	) (256
Total non-operating expenses, net	6,822	4,912	12,480	9,374
Income before income tax expense	15,841	48,511	54,399	88,217
Income tax expense	7,154	17,507	21,421	32,676
Net income	\$8,687	\$31,004	\$32,978	\$55,541
Net income per common share				
Basic	\$0.15	\$0.52	\$0.55	\$0.94
Diluted	\$0.14	\$0.52	\$0.55	\$0.93
Cash dividends declared per common share outstanding	\$0.25	\$0.23	\$0.48	\$0.44

See notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(Unaudited)

	Three Months Ended September 30,		Six Months Ended September 30,	
	2015	2014	2015	2014
Net income	8,687	31,004	32,978	55,541
Unrealized gain (loss) on available for sale securities, (net of taxes of (\$46), \$0, (\$263), \$0, respectively)	(552)	(44)	(1,400)	59)
Amortization of pension and postretirement benefit plans costs, (net of taxes of \$95, \$137, \$189 and \$275, respectively)	(227)	(221)	(380)	(443)
Pension settlement, (net of taxes of \$10,563,\$0, \$10,563, \$0, respectively)	17,029	—	17,029	—
Change in cumulative foreign currency translation adjustment	(21,841)	(21,362)	(8,043)	(16,691)
Total other comprehensive income (loss)	(5,591)	(21,627)	7,206	(17,075)
Comprehensive income	\$3,096	\$9,377	\$40,184	\$38,466

See notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended September	
	30,	
	2015	2014
Operating activities:		
Net income	\$32,978	\$55,541
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion, and amortization	46,098	47,835
Deferred income taxes	(8,903)	(1,005)
Share-based compensation expense	7,865	7,606
Pension settlement expense	26,515	—
Pension contributions	(4,687)	—
Loss (gain) on the disposal of property, plant, equipment, and intangibles, net	103	(373)
Excess tax benefit from share-based compensation	(4,676)	(4,505)
Other items	2,540	(4,985)
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable, net	31,621	39,447
Inventories, net	(19,986)	(24,251)
Other current assets	(675)	552
Accounts payable	(17,325)	(15,241)
Accruals and other, net	(11,996)	4,287
Net cash provided by operating activities	79,472	104,908
Investing activities:		
Purchases of property, plant, equipment, and intangibles, net	(39,928)	(36,527)
Proceeds from the sale of property, plant, equipment, and intangibles	38	796
Acquisition of business, net of cash acquired	(220,840)	(179,380)
Net cash used in investing activities	(260,730)	(215,111)
Financing activities:		
Proceeds from issuance of long-term obligations	350,000	—
Deferred financing fees and debt issuance costs	(2,426)	—
(Payments) proceeds under credit facilities, net	(139,750)	126,470
Repurchases of common shares	(12,974)	(5,440)
Cash dividends paid to common shareholders	(28,740)	(26,118)
Stock option and other equity transactions, net	8,111	8,686
Excess tax benefit from share-based compensation	4,676	4,505
Net cash provided by (used in) financing activities	178,897	108,103
Effect of exchange rate changes on cash and cash equivalents	(3,141)	(3,289)
Increase (decrease) in cash and cash equivalents	(5,502)	(5,389)
Cash and cash equivalents at beginning of period	167,689	152,802
Cash and cash equivalents at end of period	\$162,187	\$147,413

See notes to consolidated financial statements.

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STERIS CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

For the Three and Six Months Ended September 30, 2015 and 2014

(dollars in thousands, except per share amounts)

1. Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

STERIS Corporation, an Ohio corporation, develops, manufactures and markets infection prevention, contamination control, microbial reduction, and surgical and gastrointestinal support products and services for healthcare, pharmaceutical, scientific, research, industrial, and governmental Customers throughout the world. As used in this Quarterly Report, STERIS Corporation and its subsidiaries together are called "STERIS," the "Company," "we," "us," or "our," unless otherwise noted.

We operate in three reportable business segments: Healthcare, Life Sciences, and STERIS Isomedix Services ("Isomedix"). We describe our business segments in note 10 to our consolidated financial statements titled, "Business Segment Information." Our fiscal year ends on March 31. References in this Quarterly Report to a particular "year" or "year-end" mean our fiscal year. The significant accounting policies applied in preparing the accompanying consolidated financial statements of the Company are summarized below:

Interim Financial Statements

We prepared the accompanying unaudited consolidated financial statements of the Company according to accounting principles generally accepted in the United States ("U.S. GAAP") for interim financial information and the instructions to the Quarterly Report on Form 10-Q and Rule 10-01 of Regulation S-X. This means that they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. Our unaudited interim consolidated financial statements contain all material adjustments (including normal recurring accruals and adjustments) management believes are necessary to fairly state our financial condition, results of operations, and cash flows for the periods presented.

These interim consolidated financial statements should be read together with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the year ended March 31, 2015 dated May 27, 2015. The Consolidated Balance Sheet at March 31, 2015 was derived from the audited consolidated financial statements at March 31, 2015, but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

Principles of Consolidation

We use the consolidation method to report our investment in our subsidiaries. Therefore, the accompanying consolidated financial statements include the accounts of the Company and its wholly-owned and majority-owned subsidiaries. We eliminate inter-company accounts and transactions when we consolidate these accounts. Income attributable to non-controlling interests is reported in the "Interest income and miscellaneous expense" line of our Consolidated Statements of Income and is not material.

Use of Estimates

We make certain estimates and assumptions when preparing financial statements according to U.S. GAAP that affect the reported amounts of assets and liabilities at the financial statement dates and the reported amounts of revenues and

expenses during the periods presented. These estimates and assumptions involve judgments with respect to many factors that are difficult to predict and are beyond our control. Actual results could be materially different from these estimates. We revise the estimates and assumptions as new information becomes available. This means that operating results for the three and six month periods ended September 30, 2015 are not necessarily indicative of results that may be expected for future quarters or for the full fiscal year ending March 31, 2016.

Recent Accounting Pronouncements

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STERIS CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)

For the Three and Six Months Ended September 30, 2015 and 2014

(dollars in thousands)

Recently issued accounting standards impacting the Company are presented in the following table:

Standard	Date of Issuance	Description	Date of Adoption	Effect on the financial statements or other significant matters
Standards that have recently been adopted				
ASU 2015-03, "Simplifying the Presentation of Debt Issuance Costs"	April 2015	The update requires capitalized debt issuance costs to be presented as a reduction to the carrying value of debt instead of being classified as a deferred charge, as currently required. This update is effective for all annual and interim periods beginning after December 15, 2015 and is required to be adopted retroactively for all periods presented. Early adoption is permitted.	First Quarter Fiscal 2016	This update did not have a material impact on our consolidated financial position, results of operations or cash flows.
Standards that have not yet been adopted				
ASU 2014-09, "Revenue from Contracts with Customers"	May 2014	The standard will replace existing revenue recognition standards and significantly expand the disclosure requirements for revenue arrangements. It may be adopted either retrospectively or on a modified retrospective basis to new contracts and existing contracts with remaining performance obligations as of the effective date. The standard update is effective for annual periods beginning after December 15, 2017 and interim periods within that period. Early adoption is not permitted before the original public entity effective date of December 15, 2016.	N/A	We are currently in the process of evaluating the impact that the standard will have on our consolidated financial position, results of operations and cash flows.
ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments	September 2015	The FASB issued guidance that requires an acquirer in a business combination to recognize a measurement-period adjustment during the period in which it determines the amount, and eliminates the requirement for an acquirer to account for measurement-period adjustments retrospectively. The acquirer must also disclose the amounts and reasons for adjustments to the provisional amounts. The guidance is effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted.	N/A	We are currently in the process of evaluating the impact that the guidance will have on our consolidated financial position, results of operations and cash flows.

A detailed description of our significant and critical accounting policies, estimates, and assumptions is included in our consolidated financial statements included in our Annual Report on Form 10-K for the year ended March 31, 2015

dated May 27, 2015. Our significant and critical accounting policies, estimates, and assumptions have not changed materially from March 31, 2015.

2. Restructuring

Fiscal 2014 Restructuring Plan. During the fourth quarter of fiscal 2014, we adopted and announced a targeted restructuring plan primarily focused on the closure of our Hopkins manufacturing facility located in Mentor, Ohio (the “Fiscal 2014 Restructuring Plan”). As a result of this plan, we will transfer operations located at Hopkins to other North American locations. We believe that by closing the operations at Hopkins we will more effectively utilize our existing North American manufacturing network while reducing operating costs.

Since the inception of the Restructuring Plan we have incurred pre-tax expenses totaling \$19,008 related to these actions, of which \$10,914 was recorded as restructuring expenses and \$8,094 was recorded in cost of revenues, with restructuring expenses of \$16,932, \$796, and \$1,280 related to the Healthcare, Life Sciences and Isomedix segments, respectively. We do not

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STERIS CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)

For the Three and Six Months Ended September 30, 2015 and 2014

(dollars in thousands)

expect to incur any significant additional restructuring expenses related to this plan. These actions are intended to enhance profitability and improve efficiencies.

The following tables summarize our total pre-tax restructuring expenses for the second quarter and first six months of fiscal 2016 and fiscal 2015:

	Fiscal 2014 Restructuring Plan	
	Three months ended September 30, 2015 (1)	Six months ended September 30, 2015 (2)
Severance and other compensation related costs	\$(43)	\$(849)
Asset impairment and accelerated depreciation	19	19
Lease termination obligation and other	(13)	67
Product rationalization	22	299
Total restructuring expenses	\$(15)	\$(464)

(1) Includes \$41 in expense recorded to cost to revenues on Consolidated Statements of Income.

(2) Includes \$318 in expense recorded to cost to revenues on Consolidated Statements of Income.

	Fiscal 2014 Restructuring Plan	
	Three months ended September 30, 2014 (1)	Six months ended September 30, 2014 (2)
Severance and other compensation related costs	\$1,176	\$980
Asset impairment and accelerated depreciation	—	(38)
Lease termination obligation and other	95	157
Product rationalization	(336)	(450)
Total restructuring expenses	\$935	\$649

(1) Includes (\$336) in expense recorded to cost to revenues on Consolidated Statements of Income.

(2) Includes (\$450) in expense recorded to cost to revenues on Consolidated Statements of Income.

Liabilities related to restructuring activities are recorded as current liabilities on the accompanying Consolidated Balance Sheets within “Accrued payroll and other related liabilities” and “Accrued expenses and other.” The following table summarizes our restructuring liability balances and activity:

	Fiscal 2014 Restructuring Plan			
	March 31, 2015	Fiscal 2016 Provision (1)	Payments (1)	September 30, 2015
Severance and termination benefits	\$2,531	\$(700)	\$(239)	\$1,592
Lease termination obligations and other	356	—	(86)	270

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STERIS CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)

For the Three and Six Months Ended September 30, 2015 and 2014

(dollars in thousands)

	September 30, 2015	March 31, 2015
Land and land improvements (1)	\$38,415	\$40,668
Buildings and leasehold improvements	272,408	263,007
Machinery and equipment	386,004	375,555
Information systems	106,725	104,049
Radioisotope	298,852	289,778
Construction in progress (1)	57,951	47,690
Total property, plant, and equipment	1,160,355	1,120,747
Less: accumulated depreciation and depletion	(655,000	) (627,694
Property, plant, and equipment, net	\$505,355	\$493,053

(1) Land is not depreciated. Construction in progress is not depreciated until placed in service.

4. Inventories, Net

Inventories, net are stated at the lower of cost or market. We use the last-in, first-out (“LIFO”) and first-in, first-out cost methods. An actual valuation of inventory under the LIFO method is made only at the end of the fiscal year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management’s estimates of expected year-end inventory levels and are subject to the final fiscal year-end LIFO inventory valuation. Inventory costs include material, labor, and overhead. Inventories, net consisted of the following:

	September 30, 2015	March 31, 2015
Raw materials	\$76,165	\$67,095
Work in process	23,885	22,696
Finished goods	121,201	107,695
LIFO reserve	(17,972	) (19,071
Reserve for excess and obsolete inventory	(19,328	) (17,597
Inventories, net	\$183,951	\$160,818

5. Debt

Indebtedness was as follows:

	September 30, 2015	March 31, 2015
Private Placement	\$686,318	\$337,825
Credit Agreement and Swing Line Facility	143,500	283,250
Total long term debt	\$829,818	\$621,075

Additional information regarding our indebtedness is included in the notes to our consolidated financial statements included in our Quarterly Report on Form 10-Q for the quarter ended June 30, 2015, dated August 7, 2015, and our Annual Report on Form 10-K for the year ended March 31, 2015, dated May 27, 2015.

6. Additional Consolidated Balance Sheet Information

Additional information related to our Consolidated Balance Sheets is as follows:

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STERIS CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)—(Continued)

For the Three and Six Months Ended September 30, 2015 and 2014

(dollars in thousands)

	September 30, 2015	March 31, 2015
Accrued payroll and other related liabilities:		
Compensation and related items	\$ 15,941	\$ 16,680
Accrued vacation/paid time off	6,832	5,539
Accrued bonuses	15,202	30,159
Accrued employee commissions	10,504	12,842
Accrued pension	—	6,186
Other postretirement benefit obligations-current portion	2,789	