AMERIPATH INC
Form 10-Q
August 12, 2004
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2004

or

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

Commission File Number: 000-22313

AMERIPATH, INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware	**65-0642485**

(State or Other Jurisdiction of	**(I.R.S. Employer**
Incorporation or Organization)	**Identification No.)**
7289 Garden Road, Suite 200	
Riviera Beach, Florida	**33404**
(Address of Principal Executive Offices)	**(Zip Code)**

(561) 712-6200

(Registrant s Telephone Number, Including Area Code)

Not Applicable

(Former Name, Former Address and Formal Fiscal Year, if Changed Since Last Report)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act) Yes ¨ No x

The number of shares of Common Stock of the Registrant outstanding as of August 12, 2004 was 100.

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AMERIPATH, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands)

	(Successor)	
	June 30, 2004	December 31, 2003
	(Unaudited)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 13,038	$ 23,536
Restricted cash	12,289	12,825
Accounts receivable, net	83,912	81,595
Inventories	2,404	1,903
Income tax receivable	127	1,384
Deferred tax assets, net	13,331	13,331
Other current assets	2,676	4,469
Total current assets	127,777	139,043
PROPERTY AND EQUIPMENT, NET	28,296	27,103
OTHER ASSETS:		
Goodwill, net	541,571	532,875
Identifiable intangibles, net	181,406	186,560
Other	25,730	27,172
Total other assets	748,707	746,607
TOTAL ASSETS	$ 904,780	$ 912,753
LIABILITIES AND STOCKHOLDER S EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	$ 40,727	$ 40,314
Accrued interest	9,401	7,318
Current portion of long-term debt	291	3,450
Other current liabilities	1,873	1,873

Total current liabilities	52,292	52,955
LONG-TERM LIABILITIES:		
Long-term debt	467,685	489,008
Other liabilities	26,273	17,232
Deferred tax liabilities, net	15,048	14,883
Total long-term liabilities	509,006	521,123
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDER S EQUITY:		
Common stock, $.01 par value, 100 shares issued and outstanding at June 30, 2004 and December 31, 2003	1	1
Additional paid-in capital	337,815	334,820
Retained earnings	5,666	3,854
Total stockholder s equity	343,482	338,675
TOTAL LIABILITIES AND STOCKHOLDER S EQUITY	$ 904,780	$ 912,753

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands)

(Unaudited)

	(Successor) Three Months Ended June 30, 2004	(Successor) Three Months Ended June 30, 2003	(Successor) Six Months Ended June 30, 2004	(Predecessor) Period From January 1, 2003 through March 27, 2003	(Successor) Period From March 28, 2003 through June 30, 2003
NET REVENUES:					
Net patient service revenues	$ 119,503	$ 114,052	$ 239,123	$ 113,478	$ 114,052
Net management service revenues	5,814	5,851	11,994	5,479	5,851
Net revenues	125,317	119,903	251,117	118,957	119,903
OPERATING COSTS AND EXPENSES:					
Costs of services:					
Net patient service revenue	61,362	57,534	124,096	58,797	57,534
Net management service revenue	3,566	3,782	7,525	3,348	3,782
Total costs of services	64,928	61,316	131,621	62,145	61,316
Selling, general and administrative expenses	23,187	22,459	47,459	21,726	22,459
Provision for doubtful accounts	18,471	17,910	35,824	14,997	17,910
Amortization expense	2,753	3,095	5,567	3,107	3,095
Merger-related charges		2,404		10,010	2,404
Restructuring costs		2,044		1,196	2,044
Asset impairment and related charges			586		
Total operating costs and expenses	109,339	109,228	221,057	113,181	109,228
INCOME FROM OPERATIONS	15,978	10,675	30,060	5,776	10,675
OTHER INCOME (EXPENSES):					
Interest expense	(11,021)	(12,010)	(22,167)	(1,180)	(12,010)
Write-off of deferred financing costs	(341)		(3,829)	(957)	
Change in value of derivative	(1,275)		(1,275)		
Other income, net	110	15	180	33	15
Total other expenses, net	(12,527)	(11,995)	(27,091)	(2,104)	(11,995)
	3,451	(1,320)	2,969	3,672	(1,320)

INCOME (LOSS) BEFORE INCOME TAXES					
PROVISION FOR INCOME TAXES	1,335	1,236	1,157	2,131	1,236
NET INCOME (LOSS)	$ 2,116	$ (2,556)	$ 1,812	$ 1,541	$ (2,556)

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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AMERIPATH, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	(Successor) Six Months Ended June 30, 2004	(Predecessor) Period from January 1, 2003 through March 27, 2003	(Successor) Period from March 28, 2003 through June 30, 2003
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	$ 1,812	$ 1,541	(2,556)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation	4,467	2,130	2,230
Amortization	6,725	3,169	3,727
(Gain) loss on disposal of assets	(4)	(2)	50
Asset impairment & related charges	586		
Change in value of derivative	1,275		
Provision for doubtful accounts	35,824	14,997	17,910
Write-off of deferred financing costs	3,829	957	
Merger-related charges		10,010	2,404
Deferred income taxes			(1,406)
Changes in assets and liabilities (net of effects of acquisitions):			
Increase in accounts receivable	(38,215)	(19,607)	(10,310)
(Increase) decrease in inventories	(501)	42	(298)
Decrease in other current assets	3,051	1,321	3,145
(Increase) decrease in other assets	(632)	139	(897)
Increase (decrease) in accrued interest	2,083	(155)	
Increase (decrease) in accounts payable and accrued expenses	3,666	10,108	(20,247)
Net cash provided by (used in) operating activities	23,966	24,650	(6,248)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisitions of property and equipment	(5,656)	(2,553)	(1,983)
Acquisition and merger-related charges paid		(642)	(487)
Cash paid for acquisitions and acquisition costs, net of cash acquired	(496)	(702)	(82)
Decrease (increase) in restricted cash	536	(15)	749
Payments of contingent notes	(8,769)	(21,879)	(3,365)
Net cash used in investing activities	(14,385)	(25,791)	(5,168)
CASH FLOWS FROM FINANCING ACTIVITIES:			

Proceeds from exercise of stock options and warrants		268	
Debt issuance costs	(3,093)		(20,832)
Net payments on long-term debt and capital leases	(1,169)	(131)	(111)
Proceeds from term-loan facility			225,000
Proceeds from senior offering			275,000
Payments under term loan facility	(98,312)		(563)
Payments on former credit facility			(113,190)
Proceeds from Ameripath Holdings			296,222
Payment to Ameripath Holdings	(5,774)		
Purchase of common stock			(629,554)
Financing costs paid			(11,583)
Contingent note proceeds	8,769		3,366
Proceeds from sale of senior subordinated notes	79,500		
Tax benefit of exercise of stock options		40	
Net cash (used in) provided by financing activities	(20,079)	177	23,755
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(10,498)	(964)	12,339
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	23,536	964	
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 13,038	$	$ 12,339
SUPPLEMENTAL NON-CASH TRANSACTIONS:			
Accrual for repurchase of stock options	$	$ 9,945	$
Property and equipment acquired pursuant to capital leases		444	20

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(in thousands, unless otherwise indicated)

Note 1 Basis of Presentation

The accompanying unaudited condensed consolidated financial statements, which include the accounts of AmeriPath, Inc. and its subsidiaries (collectively, AmeriPath or the Company), have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial reporting and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the financial statements do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, such interim financial statements contain all adjustments (consisting of normal recurring items) considered necessary for a fair presentation of the Company s financial position, results of operations and cash flows for the interim periods presented. The results of operations and cash flows for any interim period are not necessarily indicative of results that may be expected for the full year.

The accompanying unaudited interim financial statements should be read in conjunction with the audited consolidated financial statements, and the notes thereto included in the Company s Form 10-K for the year ended December 31, 2003 and filed with the SEC on March 17, 2004.

In order to maintain consistency and comparability between periods presented, certain amounts in the prior year s financial statements have been reclassified to conform to the financial statement presentation of the current period.

Note 2 The March 2003 Transaction

On December 8, 2002, Amy Holding Company and its wholly-owned subsidiary, Amy Acquisition Corp., entered into a merger agreement with the predecessor of Ameripath, pursuant to which Amy Acquisition Corp. merged with and into the predecessor, with AmeriPath continuing as the surviving corporation (the March 2003 Transaction). Amy Holding Company and Amy Acquisition Corp. are Delaware corporations formed at the direction of Welsh, Carson, Anderson & Stowe IX, L.P. (WCAS). The March 2003 Transaction was approved by the Company s stockholders and subsequently consummated on March 27, 2003. References herein to our predecessor refer to the activities, financial position and results of operations of AmeriPath prior to the March 2003 Transaction. As a result of the March 2003 Transaction, AmeriPath became a wholly-owned subsidiary of Amy Holding Company, which was renamed AmeriPath Holdings, Inc. (Holdings).

The funds necessary to consummate the March 2003 Transaction were approximately $804.0 million, including approximately $629.6 million to pay the stockholders and option holders of AmeriPath (other than WCAS and its affiliates) all amounts due under the merger agreement, approximately $127.5 million to refinance existing indebtedness and approximately $46.9 million to pay related fees and expenses. Prior to the merger, the 1,534,480 shares of AmeriPath common stock owned by WCAS and its affiliates were contributed to Holdings in exchange for shares of Holdings common stock. These shares were cancelled without payment of any merger consideration. The March 2003 Transaction was financed by a cash common equity investment by WCAS and its related equity investors of $296.2 million in Holdings, which funds were contributed by Holdings to AmeriPath in exchange for shares of AmeriPath s common stock, $225.0 million in term loan borrowings under AmeriPath s New Credit Facility, the issuance of $275.0 million in senior subordinated notes and existing AmeriPath cash.

The March 2003 Transaction has been accounted for under the purchase method of accounting prescribed in Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*, (SFAS No. 141), with intangible assets recorded in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* , (SFAS No. 142). In accordance with the provisions of SFAS No. 142, no amortization of indefinite-lived intangible assets or goodwill is recorded.

As permitted under current guidance, any amounts recorded or incurred (such as goodwill or debt) by our parent as a result of the March 2003 Transaction can be pushed down and recorded on our financial statements. The following table summarizes the final allocation of the March 2003 Transaction based upon a valuation completed by an independent third-party valuation firm during September 2003.

Cash and equity contributed by WCAS	$ 319,667
Total liabilities assumed	587,801
Fair value of assets acquired	(676,458)
Excess purchase price (goodwill)	$ 231,010

In addition, Holdings issued to WCAS Capital Partners III, L.P., an investment fund affiliated with WCAS, $67.0 million in principal amount of Holdings senior subordinated notes and an agreed-upon number of shares of its common stock, for an aggregate purchase price of $67.0 million. The proceeds from this transaction were deposited into a Holdings company cash collateral account,

AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

which cash, subject to some exceptions, will be contributed to the Company from time to time to fund up to $67.0 million of future payments under the Company s contingent notes relating to acquisitions consummated prior to the March 2003 Transaction. As of June 30, 2004, approximately $23.9 million of the $67.0 million has been contributed to the Company to fund contingent note payments. The lenders under the Company s New Credit Facility have a first-priority security interest in all funds held in such cash collateral account.

For the period from January 1, 2003 through March 27, 2003 and for the period from March 28, 2003 through June 30, 2003, the Company recorded merger-related charges of approximately $10.0 million and $2.4 million, respectively, related to the March 2003 Transaction.

Note 3 Recent Accounting Pronouncements

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections* (SFAS No. 145), which, among other things, rescinded SFAS No. 4, *Reporting Gains and Losses from Extinguishment of Debt*. Previously under SFAS No. 4, all gains and losses from extinguishments of debt were required to be aggregated and, if material, classified as an extraordinary item in the statements of operations. SFAS No. 145 requires that gains and losses from extinguishments of debt be classified as extraordinary items only if they meet the criteria in Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. Any gains or losses on extinguishment of debt that were presented as extraordinary items in prior periods, but which do not qualify for classification as an extraordinary item under APB Opinion No. 30, are to be reclassified. Companies were required to adopt SFAS No. 145 in fiscal years beginning after May 15, 2002. In accordance with SFAS No. 145, the Company wrote-off approximately $3.8 million and $1.0 million of deferred financing costs during the six months ended June 30, 2004 and for the period from January 1, 2003 through March 27, 2003, respectively, relating to the prepayment of debt, which is included in other income (expense) in the condensed consolidated statements of operations.

In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities, an interpretation of ARB No. 51* (FIN 46). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the Company must apply the provisions of FIN 46 for the first interim or annual period beginning after March 15, 2004. The Company has determined that the provisions of FIN 46 do not apply to the Company.

In April 2003, the FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (SFAS No. 149). SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. It is effective for contracts entered into or modified after June 30, 2003. In April 2004, the Company entered into an interest rate swap agreement. In accordance with SFAS No. 149, the Company is recording this derivative instrument at market value and is reflecting the change in the market value in the condensed consolidated statements of operations.

Note 4 Acquisitions

During the first six months of 2004, the Company acquired one hospital-based practice in Bountiful, Utah. During the period from January 1, 2003 through March 27, 2003, the predecessor acquired a start-up operation in Charleston, South Carolina. During the period from March 28, 2003 through June 30, 2003, the successor did not have any acquisitions. The total consideration paid by the Company in connection with these acquisitions consisted of cash and contingent notes. During the six months ended June 30, 2004, for the period from January 1, 2003 through March 27, 2003, and for the period from March 28, 2003 through June 30, 2003, the Company made contingent note payments of $8.8 million, $21.9 million, and $3.4 million, respectively, relating to previous acquisitions. If the maximum specified levels of income from operations for all acquired operations are achieved, we estimate that we would make aggregate maximum principal payments of approximately $73.3 million over the next five years. A lesser amount or no payments at all would be made if the stipulated levels of income from operations or other evaluation factors specified in each agreement were not met.

The accompanying unaudited condensed consolidated financial statements include the results of operations of the Company s acquisitions accounted for under the purchase method from the date acquired through June 30, 2004.

There is no pro forma information presented for the six months ended June 30, 2004, due to the immateriality of the one acquisition consummated during 2004. There is no pro forma information presented for the period from January 1, 2003 through March 27, 2003, or for the period from March 28, 2003 through June 30, 2003, due to the immateriality of the one acquisition completed, which was a start-up operation with no revenues.

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AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Note 5 Intangible Assets

Amortization expense of identifiable intangibles was $2.8 million and $3.1 million for the three months ended June 30, 2004 and 2003, respectively. Amortization expense of identifiable intangibles was $5.6 million, $3.1 million, and $3.1 million, for the six months ended June 30, 2004, for the period from January 1, 2003 through March 27, 2003, and for the period from March 28, 2003 through June 30, 2003, respectively.

Amortization expense related to identifiable intangibles for each of the five succeeding fiscal years and thereafter as of June 30, 2004 is as follows:

Remainder of 2004	$ 5,507
2005	11,014
2006	7,814
2007	6,747
2008	5,967
2009	5,708
Thereafter	102,249

The weighted average amortization period for identifiable intangible assets is approximately 14.4 years.

Note 6 Restructuring Costs

During the period from January 1, 2003 through March 27, 2003 and for the period from March 28, 2003 through June 30, 2003, the Company incurred certain restructuring costs as promulgated by SFAS No. 146 of approximately $1.2 million and $2.0 million, respectively, for employee severance costs in connection with a reduction in workforce at our Southern California, Philadelphia, Central Florida and North Texas laboratories.

Note 7 Long-term Debt

Term Loan Facility On March 27, 2003, in connection with our consummation of the March 2003 Transaction, the predecessor terminated its existing senior credit facility and the Company entered into a new senior credit facility (the New Credit Facility) with a syndicate of financial institutions led by Credit Suisse First Boston and Deutsche Bank Securities, Inc. The write-off of the unamortized debt costs related to the former credit facility was approximately $1.0 million and is included in the predecessor statement of operations for the period from January 1, 2003 through March 27, 2003.

The New Credit Facility provided for senior secured financing of up to $290.0 million, consisting of a $225.0 million term loan facility with a maturity of seven years that was drawn in full in connection with the consummation of the March 2003 Transaction and a $65.0 million revolving credit facility with a maturity of six years. In February 2004, the Company paid down the term loan facility of the New Credit Facility to $125.0 million with proceeds from the issuance of $75.0 million of additional 10 $^{1}/2$% Senior Subordinated Notes due 2013 and the Company s cash on hand. In connection with this reduction of the term facility, the interest rate of the term loan facility and the terms and covenants of the facility were modified as reflected in the following paragraphs.

The interest rates per annum applicable to loans under the New Credit Facility are, at the Company s option, equal to either an alternate base rate or an adjusted LIBOR rate for a one, two, three or six month interest period chosen by the Company, or a nine or twelve month period if agreed to by all participating lenders, plus an applicable margin percentage in each case.

The alternate base rate is the greater of (1) the prime rate or (2) one-half of 1% over the weighted average of rates on overnight federal funds as published by the Federal Reserve Bank of New York. The adjusted LIBOR rate will be determined by reference to settlement rates established for deposits in dollars in the London interbank market for a period equal to the interest period of the loan and the maximum reserve percentages established by the Board of Governors of the United States Federal Reserve to which our lenders are subject. Beginning approximately six months after the closing of the March 2003 Transaction, the applicable margin percentage under the revolving loan facility was subject to adjustments based upon the ratio of the Company s total indebtedness to the Company s consolidated EBITDA (as defined in the New Credit Facility) being within certain defined ranges. The interest rate at June 30, 2004 was 4.28%. The facility also requires a commitment fee to be paid quarterly equal to 0.50% of any unused commitments under the revolving loan facility.

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AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Subject to exceptions, the New Credit Facility requires mandatory prepayments of the term loan in amounts equal to 100% of the net cash proceeds from asset sales which are not reinvested by the Company within specific periods, 50% of the net cash proceeds from the issuance of equity securities by the Company or Holdings, 100% of the net cash proceeds from the issuance of debt securities by the Company or Holdings if the leverage ratio is 5.25 times or greater or 50% if the leverage ratio is less than 5.25 times, and 50% of our annual excess cash flow, less all voluntary prepayments made during the year.

The New Credit Facility requires scheduled quarterly payments on the term loan in amounts equal to $312,500 on each of June 30, September 30, December 31 and March 31, beginning on June 30, 2004. On June 30, 2004, the Company made its mandatory payment of $312,500 and also made a voluntary prepayment of $9,687,500. The voluntary prepayment was applied chronologically to the future mandatory quarterly payments. Therefore, the next mandatory payment on the facility will not be until 2009. As a result of the voluntary paydown, the Company recognized a $0.3 million write-off of deferred debt costs.

Indebtedness under the New Credit Facility is guaranteed by all of the Company s current restricted subsidiaries, certain of its future restricted subsidiaries and by Holdings. It is secured by a first priority security interest in substantially all of the Company s existing and future property and assets, including accounts receivable, inventory, equipment, general intangibles, intellectual property, investment property, other personal property, owned and material leased real property, cash and cash proceeds of the foregoing and a first priority pledge of the Company s capital stock and the capital stock of the guarantor subsidiaries.

The New Credit Facility requires that the Company comply on a quarterly basis with certain financial covenants, including an interest coverage ratio calculation, a fixed charge coverage ratio calculation and a maximum net senior leverage ratio calculation, which become more restrictive over time. In addition, the New Credit Facility includes negative covenants restricting or limiting the Company s ability and the ability of its subsidiaries to, among other things, incur, assume or permit to exist additional indebtedness or guarantees; incur liens and engage in sale leaseback transactions; make capital expenditures; make loans and investments; declare dividends, make payments or redeem or repurchase capital stock; engage in mergers, acquisitions and other business combinations; prepay, redeem or purchase certain indebtedness; amend or otherwise alter terms of our indebtedness; sell assets; transact with affiliates and alter the business that it conducts.

Such negative covenants are subject to exceptions, including, with respect to restrictions on dividends from the Company to Holdings, certain allowable dividends to pay cash interest on its parent s Holding company notes beginning in the fiscal year ending December 31, 2004.

Senior Subordinated Notes On March 27, 2003, in connection with the March 2003 Transaction, Amy Acquisition Corp. issued $275.0 million of 10 $^1/2$% Senior Subordinated Notes due 2013. The Company assumed Amy Acquisition Corp. s obligations with respect to the notes upon consummation of the March 2003 Transaction. Interest became payable semi-annually in arrears beginning in October 2003. The notes are unconditionally guaranteed, jointly and severally and on an unsecured senior subordinated basis, by certain of the Company s current and former subsidiaries. The notes and guarantees rank junior to all of the Company s and the subsidiary guarantors existing and future senior indebtedness, on par with all of the Company s and the subsidiary guarantors existing and future senior subordinated indebtedness and senior to all of the Company s and the subsidiary guarantors existing and future subordinated indebtedness. On April 1, 2004, the Company made its semi-annual interest payment of approximately $18.4 million.

The Company may redeem any of the notes at any time and from time to time beginning on April 1, 2008, in whole or in part, in cash at the specified redemption prices, plus accrued and unpaid interest to the date of redemption.

If a change in control of the Company occurs, subject to certain conditions, the Company must give holders of the notes an opportunity to sell the notes to the Company at a purchase price of 101% of the principal amount of the notes, plus accrued and unpaid interest to the date of the purchase of the notes by the Company.

The indenture governing the notes contains covenants that, among other things, limit the Company s ability and the ability of the Company s restricted subsidiaries to incur or guarantee additional indebtedness, pay dividends or make other equity distributions, purchase or redeem capital stock, make certain investments, enter into arrangements that restrict dividends from subsidiaries, transfer and sell assets, engage in certain transactions with affiliates and effect a consolidation or merger.

In February 2004, the Company issued an additional $75.0 million of its 10 $^{1}/2$% Senior Subordinated Notes due 2013 at a premium price of 106% plus accrued interest. In February 2004, the Company paid down $88.2 million of the term loan borrowings. As a result of the paydown, the Company recognized a $3.5 million write-off of deferred financing costs.

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AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Letters of Credit

As of June 30, 2004, the Company had letters of credit outstanding totaling $2.8 million. The letters of credit secure payments under certain operating leases and expire at various dates in 2004 through 2009. Some of the letters of credit automatically decline in value over various lease terms. The letters of credit have annual fees averaging 3.5%. Available borrowings under the $65 million revolving credit facility are reduced by the balance outstanding on these letters of credit. In addition, the Company had $300,000 of surety bonds outstanding on June 30, 2004 to satisfy Florida Medicaid requirements.

Note 8 Derivative Instrument

In April 2004, the Company entered into a 2 1/2 year interest rate swap transaction which involves the exchange of fixed for floating rate interest payments without the exchange of the underlying principal amount. The interest differential to be paid or received is accrued and is recognized as an adjustment to interest expense. The change in the market value of the derivative instrument is recognized in the condensed consolidated statements of operations. For the six months ended June 30, 2004, the change in the value of the derivative was a loss of approximately $1.3 million. The agreement has a notional amount of $75.0 million. The Company receives interest on the notional amount if the LIBOR rate is less than 2.405% and pays interest on the notional amount if the LIBOR rate exceeds 2.405%. This derivative instrument is being used by the Company to reduce interest rate volatility and associated risks arising from the fixed rate structure of our Senior Subordinated Notes, and is not held or issued for trading purposes.

Note 9 Commitments and Contingencies

During the fourth quarter of 2002, two civil actions were commenced in the Circuit Court of the 15th Judicial Circuit in and for Palm Beach County, Florida. The two actions were consolidated on February 14, 2003 and an Amended Complaint was filed on March 6, 2003. The Amended Complaint alleged a breach of duty to stockholders in connection with the March 2003 Transaction. The plaintiffs sought to represent a putative class consisting of the former public stockholders of AmeriPath, Inc. Named as defendants in the Amended Complaint were AmeriPath, Inc. and the members of the AmeriPath, Inc. board of directors. The plaintiffs alleged, among other things, that the consideration was inadequate, that the announcement was improperly timed, that AmeriPath, Inc. was not properly auctioned, that the March 2003 Transaction was unfair, that the proxy statement omitted certain information that the plaintiffs contend was material and that such AmeriPath, Inc. directors breached their fiduciary duties. The Amended Complaint sought injunctive relief against consummation of the merger, unspecified amounts of damages, costs and expenses related to their actions and other unspecified relief. The Company believed the Amended Complaint lacked merit and moved to dismiss it. Notwithstanding this motion, the Company and the plaintiffs agreed to a non-class settlement that was funded by the Company s Directors and Officers insurance carrier, and was in the range of future defense costs and did not materially impact the Company s financial statements or operations. The litigation was voluntarily dismissed with prejudice on May 18, 2004.

During the ordinary course of business, the Company has become and may in the future become subject to legal actions and proceedings. The Company may have liability with respect to its employees and its pathologists and with respect to hospital employees who are under the supervision of its hospital-based pathologists. The majority of these pending legal proceedings involve claims of medical malpractice and most of those suits relate to cytology services. Based upon investigations conducted to date, the Company believes the outcome of any pending legal actions and proceedings, individually or in the aggregate, will not have a material adverse effect on the Company s financial condition, results of operations or liquidity. If the Company is ultimately found liable under the outstanding medical malpractice claims, there can be no assurance that medical malpractice insurance arrangements will be adequate to cover all such liabilities. The Company also may, from time to time, be involved with legal actions related to the acquisition of anatomic pathology operations, the prior conduct of acquired operations or the employment and restriction on competition of physicians. There can be no assurance that any costs or liabilities for which the Company becomes responsible in connection with these claims or actions will not be material or will not exceed the limitations of any applicable indemnification provisions or the financial resources of the indemnifying parties.

Healthcare Regulatory Environment and Reliance on Government Programs The healthcare industry in general, and the services that the Company provides, are subject to extensive federal and state laws and regulations. Additionally, a significant portion of the Company s net revenue is from payments by government-sponsored health care programs, principally Medicare and Medicaid, and is subject to audits and adjustments by applicable regulatory agencies. Failure to comply with any of these laws or regulations, the results of increased regulatory audits and adjustments, or changes in the interpretation of the coding of services or the amounts payable for the Company s services under these programs could have a material adverse effect on the Company s financial position and results of operations. The Company s operations are continuously subject to review and inspection by regulatory authorities.

AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

The Company has received subpoenas issued by the United States Attorney s office in Tampa, Florida seeking information with respect to an investigation relating to Medicare billing and possible financial inducements in connection with a Florida physician who is not an AmeriPath pathologist but is a client of AmeriPath. The Company is providing information to the United States Attorney s office and intends to cooperate in the investigation. The Company is conducting its own internal investigation of the matter. It is not possible at this point in the investigation to determine whether the government will pursue action against AmeriPath or to assess the merits of possible defenses AmeriPath might have to any such action. Accordingly, no assurances can be given regarding the ultimate outcome of the investigation.

Employment Agreements As part of the March 2003 Transaction, the Company entered into new or amended employment agreements with certain of its management employees, which included, among other terms, non-competition provisions and salary continuation benefits. The Company also terminated employment contracts with certain of its management employees as a result of the March 2003 Transaction, which resulted in change in control payments to those former employees and are included in merger-related charges for the period from January 1, 2003 through March 27, 2003. In March 2004, Donald E. Steen became the Company s Chairman of the Board of Directors. Effective as of July 1, 2004, Mr. Steen became Chief Executive Officer of the Company and entered into an employment contract with the Company.

Medicare Reimbursement The Medicare statute includes a methodology to adjust payments for services, including anatomic pathology services, under the physician fee schedule. This methodology is applied each year unless it is overridden by Congressional action. The statutory methodology would have led to a 4.4% reduction in the physician fee schedule conversion factor in 2003 and a 4.5% reduction in 2004 if those reductions had not been blocked by Congress. Instead, Congress required a 1.6% increase in 2003 and a 1.5% increase in each of 2004 and 2005. In addition, because it was projected that the statutory methodology would result in additional reductions in the physician fee schedule conversion factor in future years, Congress revised the methodology through legislation enacted in December 2003. It is unclear how this revision in the methodology will affect the annual adjustments in the physician fee schedule conversion factor in future years and, if it will not prevent reductions, whether Congress will intervene to prevent decreases in the physician fee schedule conversion factor in future years.

Note 10 Comprehensive Income

In accordance with SFAS No. 130, *Reporting Comprehensive Income* (SFAS 130), the Company is required to report and display certain information related to comprehensive income. For the six months ended June 30, 2004, for the period from January 1, 2003 through March 27, 2003, and for the period from March 28, 2003 through June 30, 2003, net income equaled comprehensive income.

Note 11 Segment Reporting

The Company has two reportable segments, owned operations and managed operations. The segments were determined based on the type of service performed and customers. Owned operations provide anatomic pathology services to hospitals and referring physicians, while the Company s managed operations provide management services to the affiliated physician groups. The accounting policies of the segments are the same as those described in the summary of accounting policies in the Company s year-end audited financial statements. The Company evaluates performance based on net revenue and income from operations.

The following is a summary of financial information for the three months ended June 30, 2004 and 2003, six months ended June 30, 2004, the period from January 1, 2003 through March 27, 2003, and the period from March 28, 2003 through June 30, 2003 for the Company s business segments and corporate offices:

	(Successor) Three months ended June 30,		(Successor) Six months ended June 30,	(Predecessor) Period from January 1, 2003 through March 27,	(Successor) Period from March 28, 2003 through June 30,
	2004	2003	2004	2003	2003
Owned					
Net patient service revenue	$ 119,503	$ 114,052	$ 239,123	$ 113,478	$ 114,052
Income from operations	26,139	23,063	51,549	23,900	23,063
Segment assets			777,506		797,105
Managed					
Net management service revenue	$ 5,814	$ 5,851	$ 11,994	$ 5,479	$ 5,851
Income from operations	707	495	1,396	558	495
Segment assets			17,152		22,818
Corporate					
Loss from operations	$ (10,868)	$ (12,883)	$ (22,885)	$ (18,682)	$ (12,883)
Segment assets			100,571		302,100
Elimination of intercompany accounts			9,551		(157,303)

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AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Note 12 Income Taxes

The Company s effective income tax rate was 39.0%, 58.0%, and 93.6% for the six-month period ended June 30, 2004, for the period from January 1, 2003 through March 27, 2003, and for the period from March 28, 2003 through June 30, 2003, respectively.

This rate decreased significantly from the prior period primarily due to the non-deductibility of certain merger-related charges relating to the March 2003 Transaction.

Note 13 Guarantor Subsidiaries

The following information is presented as required by regulations of the Securities and Exchange Commission in connection with the Company s 10 1/2% Senior Subordinated Notes due 2013. This information is not routinely prepared for use by management. The operating and investing activities of the separate legal entities included in the Company s condensed consolidated financial statements are fully interdependent and integrated. Accordingly, consolidating the operating results of those separate legal entities is not representative of what the actual operating results of those entities would be on a stand-alone basis. Operating expenses of those separate legal entities include intercompany charges for management fees and other services. Certain expense items and asset and liability balances that are applicable to the Company s subsidiaries are typically recorded in the books and records of AmeriPath, Inc. For purposes of this footnote disclosure, such balances and amounts have been pushed down to the respective subsidiaries either on a specific identification basis, or when such items cannot be specifically attributed to an individual subsidiary, have been allocated on an incremental or proportional cost basis to AmeriPath, Inc. and the Company s subsidiaries.

The following tables present condensed consolidating financial information at June 30, 2004, at December 31, 2003, for the six months ending June 30, 2004, the period from January 1, 2003 through March 27, 2003, and for the period from March 28, 2003 through June 30, 2003, for (i) AmeriPath, (ii) on a combined basis, the subsidiaries of AmeriPath that are guarantors of the Company s 10 1/2% Senior Subordinated Notes due 2013 (the Subsidiary Guarantors) and (iii) on a combined basis, the subsidiaries of AmeriPath that are not guarantors of the Company s 10 1/2% Senior Subordinated Notes due 2013 (the Non-Guarantor Subsidiaries). The maximum potential amount of future payments the subsidiary Guarantors could be required to make under the Guarantee is $350.0 million.

Condensed Consolidating Balance Sheets:

Successor:

As of June 30, 2004	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Assets					
Current assets:					
Cash	$	$ 12,309	$ 729		$ 13,038
Restricted cash		12,289			12,289
Accounts receivable, net	142	66,876	16,894		83,912
Inventories	128	2,276			2,404
Other current assets	1,875	10,265	3,994		16,134
Total current assets	2,145	104,015	21,617		127,777
Property & equipment, net	2,686	25,610			28,296
Goodwill, net		420,692	120,879		541,571
Other identifiable intangibles, net	20,100	128,727	32,579		181,406
Investment in subsidiaries	694,430	(6,632)		(687,798)	
Other assets	19,287	5,454	989		25,730
Total assets	$ 738,648	$ 677,866	$ 176,064	$ (687,798)	$ 904,780
Liabilities and Stockholder s Equity					
Current liabilities:					
Accounts payable and accrued expenses	$ 17,220	$ 27,428	$ 5,480		$ 50,128
Current portion of long-term debt		291			291
Other current liabilities	(56)	1,929			1,873
Total current liabilities	17,164	29,648	5,480		52,292
Long-term debt	465,000	2,685			467,685
Other liabilities	5,595	18,976	1,702		26,273
Deferred tax liabilities, net	122	16,032	(1,106)		15,048
Total long-term liabilities	470,717	37,693	596		509,006
Intercompany payable (receivable)	277,450	(269,472)	(7,978)		
Stockholder s equity:					
Common stock	(1,382)	1,381	25	(23)	1
Additional paid-in capital	301,068	33,756	2,991		337,815
Retained earnings (deficit)	(326,369)	844,861	174,949	(687,775)	5,666
Total stockholder s equity	(26,683)	879,998	177,965	(687,798)	343,482
Total liabilities and stockholder s equity	$ 738,648	$ 677,867	$ 176,063	$ (687,798)	$ 904,780

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AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Successor:

As of December 31, 2003	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
Assets					
Current assets:					
Cash	$	$ 22,652	$ 884		$ 23,536
Restricted cash		12,825			12,825
Accounts receivable, net	259	66,227	15,109		81,595
Inventories	142	1,761			1,903
Other current assets	1,793	13,332	4,059		19,184
Total current assets	2,194	116,797	20,052		139,043
Property & equipment, net	2,029	25,007	67		27,103
Goodwill, net		413,301	119,574		532,875
Other identifiable intangibles, net	20,300	131,469	34,791		186,560
Investment in subsidiaries	684,593	(6,630)		(677,963)	
Other assets	20,896	5,469	807		27,172
Total assets	$ 730,012	$ 685,413	$ 175,291	$ (677,963)	$ 912,753
Liabilities and Stockholder s Equity					
Current liabilities:					
Accounts payable and accrued expenses	$ 5,505	$ 36,413	$ 5,714		$ 47,632
Current portion of long-term debt	2,149	1,301			3,450
Other current liabilities	(12)	1,885			1,873
Total current liabilities	7,642	39,599	5,714		52,955
Long-term debt	487,135	1,873			489,008
Other liabilities	5,138	11,213	881		17,232
Deferred tax liabilities, net	122	15,867	(1,106)		14,883
Total long-term liabilities	492,395	28,953	(225)		521,123
Intercompany payable (receivable)	224,996	(227,456)	2,460		
Stockholder s equity:					
Common stock	(1,382)	1,379	25	(21)	1
Additional paid-in capital	300,092	31,719	3,009		334,820
Retained earnings (deficit)	(293,731)	811,219	164,308	(677,942)	3,854
Total stockholder s equity	4,979	844,317	167,342	(677,963)	338,675
Total liabilities and stockholder s equity	$ 730,012	$ 685,413	$ 175,291	$ (677,963)	$ 912,753

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AMERIPATH, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED) (Continued)

Condensed Consolidating Statements of Operations:

Successor:

For the six months ended June 30, 2004	AmeriPath, Inc.	Subsidiary Guarantors	Non Guarantor Subsidiaries	Consolidated Total
Net revenues	$	$ 195,057	$ 56,060	$ 251,117
Cost of services		(109,662)	(21,959)	(131,621)
Selling, general and administrative expense	(4,252)	(69,699)	(9,332)	(83,283)
Amortization expense		(4,925)	(642)	(5,567)
Merger-related charges				
Restructuring costs				
Asset impairment & related charges			(586)	(586)
Total operating costs and expense	(4,252)	(184,286)	(32,519)	(221,057)

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