DAVITA INC
Form 10-Q
May 03, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

For the Quarterly Period Ended

March 31, 2010

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 1-14106

DAVITA INC.

1551 Wewatta Street

Denver, CO 80202

Telephone number (303) 405-2100

Delaware	**51-0354549**
(State of incorporation)	**(I.R.S. Employer Identification No.)**

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 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 x 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 x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

(Do not check if a smaller reporting company)

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

As of April 29, 2010, the number of shares of the Registrant s common stock outstanding was approximately 103.9 million shares and the aggregate market value of the common stock outstanding held by non-affiliates based upon the closing price of these shares on the New York Stock Exchange was approximately $6.6 billion.

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DAVITA INC.

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DAVITA INC.

CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(dollars in thousands, except per share data)

	Three months ended March 31, 2010	Three months ended March 31, 2009
Net operating revenues	$ 1,559,418	$ 1,447,640
Operating expenses and charges:		
Patient care costs	1,082,789	1,005,886
General and administrative	137,277	127,273
Depreciation and amortization	57,468	57,123
Provision for uncollectible accounts	41,563	36,736
Equity investment (income) loss	(2,345)	18
Total operating expenses and charges	1,316,752	1,227,036
Operating income	242,666	220,604
Debt expense	(44,583)	(48,301)
Other income	831	754
Income before income taxes	198,914	173,057
Income tax expense	73,914	64,783
Net income	125,000	108,274
Less: Net income attributable to noncontrolling interests	(15,577)	(12,063)
Net income attributable to DaVita Inc.	$ 109,423	$ 96,211
Earnings per share:		
Basic earnings per share attributable to DaVita Inc.	$ 1.05	$ 0.93
Diluted earnings per share attributable to DaVita Inc.	$ 1.04	$ 0.92
Weighted average shares for earnings per share:		
Basic	103,364,869	103,878,417
Diluted	104,765,600	104,409,026

See notes to condensed consolidated financial statements.

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DAVITA INC.

CONSOLIDATED BALANCE SHEETS

(unaudited)

(dollars in thousands, except per share data)

	March 31, 2010	December 31, 2009
ASSETS		
Cash and cash equivalents	$ 755,909	$ 539,459
Short-term investments	22,907	26,475
Accounts receivable, less allowance of $230,769 and $229,317	1,103,786	1,105,903
Inventories	68,038	70,041
Other receivables	225,038	263,456
Other current assets	34,485	40,234
Deferred income taxes	251,088	256,953
Total current assets	2,461,251	2,302,521
Property and equipment, net	1,093,850	1,104,925
Amortizable intangibles, net	129,285	136,732
Equity investments	23,965	22,631
Long-term investments	7,584	7,616
Other long-term assets	33,397	32,615
Goodwill	3,942,386	3,951,196
	$ 7,691,718	$ 7,558,236
LIABILITIES AND EQUITY		
Accounts payable	$ 177,764	$ 176,657
Other liabilities	412,515	461,092
Accrued compensation and benefits	299,709	286,121
Current portion of long-term debt	98,844	100,007
Income taxes payable	58,643	23,064
Total current liabilities	1,047,475	1,046,941
Long-term debt	3,509,713	3,532,217
Other long-term liabilities	89,634	87,692
Alliance and product supply agreement, net	29,315	30,647
Deferred income taxes	346,460	334,855
Total liabilities	5,022,597	5,032,352
Commitments and contingencies		
Noncontrolling interests subject to put provisions	350,485	331,725
Equity:		
Preferred stock ($0.001 par value, 5,000,000 shares authorized; none issued)		
Common stock ($0.001 par value, 450,000,000 shares authorized; 134,862,283 shares issued; 103,793,205 and 103,062,698 shares outstanding)	135	135
Additional paid-in capital	617,891	621,685
Retained earnings	2,421,557	2,312,134
Treasury stock, at cost (31,069,078 and 31,799,585 shares)	(775,115)	(793,340)
Accumulated other comprehensive loss	(3,320)	(5,548)

Total DaVita Inc. shareholders equity	2,261,148	2,135,066
Noncontrolling interests not subject to put provisions	57,488	59,093
Total equity	2,318,636	2,194,159
	$ 7,691,718	$ 7,558,236

See notes to condensed consolidated financial statements.

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DAVITA INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(dollars in thousands)

	Three months ended March 31,	
	2010	**2009**
Cash flows from operating activities:		
Net income	$ 125,000	$ 108,274
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	57,468	57,123
Stock-based compensation expense	10,233	11,009
Tax benefits from stock award exercises	7,873	2,161
Excess tax benefits from stock award exercises	(1,378)	(779)
Deferred income taxes	(3,311)	16,430
Equity investment (income) loss	(1,334)	18
(Gain) loss on disposal of assets and other non-cash charges	(695)	7,051
Changes in operating assets and liabilities, other than from acquisitions and divestitures:		
Accounts receivable	594	(13,757)
Inventories	1,818	13,055
Other receivables and other current assets	44,343	41,417
Other long-term assets	(782)	1,422
Accounts payable	1,800	(65,411)
Accrued compensation and benefits	17,349	(21,403)
Other current liabilities	(45,063)	(54,116)
Income taxes	47,617	40,339
Other long-term liabilities	315	(8,584)
Net cash provided by operating activities	261,847	134,249
Cash flows from investing activities:		
Additions of property and equipment	(42,585)	(73,203)
Acquisitions	(1,069)	(39,828)
Proceeds from asset sales	16,264	4,199
Purchase of investments available for sale	(521)	(514)
Purchase of investments held-to-maturity	(12,522)	(6)
Proceeds from sale of investments available for sale	880	10,669
Proceeds from maturities of investments held-to-maturity	15,990	20
Purchase of equity investments	(350)	
Distributions received on equity investments	350	
Net cash used in investing activities	(23,563)	(98,663)
Cash flows from financing activities:		
Borrowings	4,877,000	2,619,540
Payments on long-term debt	(4,902,041)	(2,630,739)
Purchase of treasury stock		(32,016)
Excess tax benefits from stock award exercises	1,378	779
Stock award exercises and other share issuances, net	21,073	9,102
Distributions to noncontrolling interests	(18,658)	(13,567)

Contributions from noncontrolling interests	1,613	4,460
Proceeds from sales of additional noncontrolling interests	108	3,081
Purchases from noncontrolling interests	(2,307)	(1,424)
Net cash used in financing activities	(21,834)	(40,784)
Net increase (decrease) in cash and cash equivalents	216,450	(5,198)
Cash and cash equivalents at beginning of period	539,459	410,881
Cash and cash equivalents at end of period	$ 755,909	$ 405,683

See notes to condensed consolidated financial statements.

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DAVITA INC.

CONSOLIDATED STATEMENTS OF EQUITY

AND COMPREHENSIVE INCOME

(unaudited)

(dollars and shares in thousands)

		DaVita Inc. Shareholders Equity									
	Non-controlling interests subject to put provisions	Common stock				Treasury stock				Non-controlling interests not subject to put provisions	
		Shares	Amount	Additional paid-in capital	Retained earnings	Shares	Amount	Accumulated other comprehensive income (loss)	Total		Comprehensive income
Balance at December 31, 2008	$ 291,397	134,862	$ 135	$ 584,358	$ 1,889,450	(31,109)	$ (691,857)	$ (14,339)	$ 1,767,747	$ 59,152	$
Comprehensive income:											
Net income	38,381				422,684				422,684	18,694	479,759
Unrealized losses on interest rate swaps, net of tax								(2,578)	(2,578)		(2,578)
Less reclassification of net swap realized losses into net income, net of tax								10,542	10,542		10,542
Unrealized gains on investments, net of tax								986	986		986
Less reclassification of net investment realized gains into net income, net of tax								(159)	(159)		(159)
Total comprehensive income											$ 488,550
Stock purchase shares issued				2,135		107	2,387		4,522		
Stock unit shares issued				(1,570)		69	1,570				
Stock options and SSARs exercised				15,598		2,036	48,055		63,653		
Stock-based compensation expense				44,422					44,422		
Excess tax benefits from stock awards exercised				6,150					6,150		
Distributions to noncontrolling interests	(44,277)									(23,471)	
Contributions from noncontrolling interests	10,502									2,569	
Sales and assumptions of additional noncontrolling interests	13,483			(529)					(529)	4,039	

Purchases from noncontrolling interests	(2,594)			(3,721)					(3,721)	(544)	
Changes in fair value of noncontrolling interests	24,819			(24,819)					(24,819)		
Other adjustments	14			(339)					(339)	(1,346)	
Purchase of treasury stock						(2,903)	(153,495)		(153,495)		
Balance at December 31, 2009	$ 331,725	134,862	$ 135	$ 621,685	$ 2,312,134	(31,800)	$ (793,340)	$ (5,548)	$ 2,135,066	$ 59,093	
Comprehensive income:											
Net income	9,608				109,423				109,423	5,969	125,000
Unrealized losses on interest rate swaps, net of tax								(173)	(173)		(173)
Less reclassification of net swap realized losses into net income, net of tax								2,187	2,187		2,187
Unrealized gains on investments, net of tax								200	200		200
Less reclassification of net investment realized losses into net income, net of tax								14	14		14
Total comprehensive income											$ 127,228
Stock purchase shares issued				2,130		86	2,151		4,281		
Stock unit shares issued				(84)		4	84				
Stock options and SSARs exercised				4,129		641	15,990		20,119		
Stock-based compensation expense				10,233					10,233		
Excess tax benefits from stock awards exercised				419					419		
Distributions to noncontrolling interests	(11,509)									(7,149)	
Contributions from noncontrolling interests	975									638	
Sales and assumptions of additional noncontrolling interests				52					52	257	
Purchases from noncontrolling interests	(1,200)			213					213	(1,320)	
Changes in fair value of noncontrolling interests	20,886			(20,886)					(20,886)		
Balance at March 31, 2010	$ 350,485	134,862	$ 135	$ 617,891	$ 2,421,557	(31,069)	$ (775,115)	$ (3,320)	$ 2,261,148	$ 57,488	

See notes to condensed consolidated financial statements.

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(dollars and shares in thousands)

Unless otherwise indicated in this Quarterly Report on Form 10-Q “the Company , we , us , our and similar terms refer to DaVita Inc. and its consolidated subsidiaries.

1. Condensed consolidated interim financial statements

The condensed consolidated interim financial statements included in this report are prepared by the Company without audit. In the opinion of management, all adjustments consisting only of normal recurring items necessary for a fair presentation of the results of operations are reflected in these consolidated interim financial statements. All significant intercompany accounts and transactions have been eliminated. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. The most significant estimates and assumptions underlying these financial statements and accompanying notes generally involve revenue recognition and provisions for uncollectible accounts, impairments and valuation adjustments, fair value estimates, accounting for income taxes, variable compensation accruals, purchase accounting valuation estimates and stock-based compensation. The results of operations for the three months ended March 31, 2010 are not necessarily indicative of the operating results for the full year. The consolidated interim financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. Prior year balances and amounts have been classified to conform to the current year presentation. The Company has evaluated subsequent events through the date these condensed consolidated financial statements were issued and have included all necessary disclosures.

2. Earnings per share

Basic net income per share is calculated by dividing net income attributable to DaVita Inc. net of the increase in noncontrolling interest redemption rights in excess of fair value, by the weighted average number of common shares and vested stock units outstanding. Diluted net income per share includes the dilutive effect of outstanding stock options, stock-settled stock appreciation rights and unvested stock units (under the treasury stock method).

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars and shares in thousands)

The reconciliations of the numerators and denominators used to calculate basic and diluted earnings per share are as follows:

	Three months ended March 31, 2010	2009
	(shares in thousands)	
Basic:		
Net income attributable to DaVita Inc.	$ 109,423	$ 96,211
Increase in noncontrolling interest redemption rights in excess of fair value	$ (869)	$
Net income for basic earnings per share calculation	$ 108,554	$ 96,211
Weighted average shares outstanding during the period	103,356	103,869
Vested stock units	9	9
Weighted average shares for basic earnings per share calculation	103,365	103,878
Basic net income per share attributable to DaVita Inc	$ 1.05	$ 0.93
Diluted:		
Net income for diluted earnings per share calculation	$ 109,423	$ 96,211
Increase in noncontrolling interest redemption rights in excess of fair value	$ (869)	$
Net income for diluted earnings per share calculation	$ 108,554	$ 96,211
Weighted average shares outstanding during the period	103,356	103,869
Vested stock units	9	9
Assumed incremental shares from stock plans	1,401	531
Weighted average shares for diluted earnings per share calculation	104,766	104,409
Diluted net income per share attributable to DaVita Inc.	$ 1.04	$ 0.92
Shares subject to anti-dilutive awards excluded from calculation [1]	651	12,811

[1] Shares associated with stock options and stock-settled stock appreciation rights that are excluded from the diluted denominator calculation because they are anti-dilutive under the treasury stock method.

3. Stock-based compensation and other common stock transactions

Stock-based compensation recognized in a period represents the amortization during that period of the estimated grant-date fair value of current and prior stock-based awards over their vesting terms, adjusted for expected forfeitures. Shares issued upon exercise of stock awards are generally issued from shares in treasury. The Company has used the Black-Scholes-Merton valuation model for estimating the grant-date fair value of stock options and stock-settled stock appreciation rights granted in all periods. During the three months ended March 31, 2010, the Company granted 1,225 stock-settled stock appreciation rights with a grant-date fair value of $19,402 and a weighted-average expected life of approximately 3.6 years, and also granted 291 stock units with a grant-date fair value of $18,419 and a weighted-average expected life of approximately 2.7 years.

For the three months ended March 31, 2010 and 2009, the Company recognized $10,233 and $11,009, respectively, in stock-based compensation expense for stock options, stock-settled stock appreciation rights, stock units and discounted employee stock plan purchases, which are primarily included in general and

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars and shares in thousands)

administrative expenses. The estimated tax benefit recorded for stock-based compensation through March 31, 2010 and 2009 was $3,880 and $4,171, respectively. As of March 31, 2010, there was $100,585 of total estimated unrecognized compensation cost related to nonvested stock-based compensation arrangements under our equity compensation and stock purchase plans. The Company expects to recognize this cost over a weighted average remaining period of 1.6 years.

During the three months ended March 31, 2010 and 2009, the Company received $20,119 and $8,035, respectively, in cash proceeds from stock option exercises and $7,873 and $2,161, respectively, in actual tax benefits upon the exercise of stock awards.

In connection with a proposal to stockholders requesting approval of an increase in the number of shares authorized for issuance under the Company s equity compensation plan, the Board of Directors has committed to our stockholders that over the three-year period commencing on April 1, 2010 it will not grant a number of shares subject to stock awards under the Company s equity compensation plan, including stock options, stock appreciation rights, restricted stock units or other stock awards, at an average annual rate greater than 4.02% of the number of shares of our common stock that we believe will be outstanding over such three-year period. This 4.02% rate is the average of the 2009 and 2010 three-year average median grant rate plus one standard deviation as published by RiskMetrics Group for the Russell 3000 companies in the GICS 3510 industry segment. Awards that are settled in cash, awards that are granted pursuant to stockholder approved exchange programs, awards sold under our employee stock purchase plan and awards assumed or substituted in business combination transactions will be excluded from our grant rate calculation. For purposes of calculating the number of shares granted, any full-value awards (i.e., restricted stock, restricted stock unit, performance share or any other award that does not have an exercise price per share at least equal to the per share fair market value of our common stock on the grant date) will count as equivalent to 3.0 shares. The Company will publicly report its compliance with this three-year average annual grant rate commitment, and the data necessary to independently confirm it, in a public filing shortly after March 31, 2013.

4. Long-term debt

Long-term debt was comprised of the following:

	March 31, 2010	December 31, 2009
Senior secured credit facilities:		
Term loan A	$ 131,250	$ 153,125
Term loan B	1,705,875	1,705,875
Senior and senior subordinated notes	1,750,000	1,750,000
Acquisition obligations and other notes payable	12,839	15,891
Capital lease obligations	6,106	4,635
Total debt principal outstanding	3,606,070	3,629,526
Premium on the 6 5/8% senior notes	2,487	2,698
	3,608,557	3,632,224
Less current portion	(98,844)	(100,007)
	$ 3,509,713	$ 3,532,217

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars and shares in thousands)

Scheduled maturities of long-term debt at March 31, 2010 are as follows:

2010 (remainder of the year)	76,671
2011	66,912
2012	1,706,956
2013	901,124
2014	546
2015	850,318
Thereafter	3,543

On April 30, 2010, the Company notified the Trustee that it is exercising its right to redeem $200,000 aggregate principal amount of its outstanding 6 $^{5}/8$% senior notes due 2013, at a price of 101.656% and the redemption date is expected to be in June 2010. The Company expects to expense net pre-tax refinancing charges of approximately $4,000 in the second quarter of 2010, associated with the transaction.

During the first three months of 2010, the Company made mandatory principal payments totaling $21,875 on the term loan A.

The Company has entered into several interest rate swap agreements as a means of hedging its exposure to and volatility from variable-based interest rate changes as part of its overall risk management strategy. These agreements are not held for trading or speculative purposes, and have the economic effect of converting portions of our variable rate debt to a fixed rate. These agreements are designated as cash flow hedges, and as a result, hedge-effective gains or losses resulting from changes in the fair values of these swaps are reported in other comprehensive income until such time as each specific swap tranche is realized, at which time the amounts are reclassified into net income. Net amounts paid or received for each specific swap tranche that have settled have been reflected as adjustments to debt expense. These agreements do not contain credit-risk contingent features.

As of March 31, 2010, the Company maintained a total of six interest rate swap agreements with amortizing notional amounts totaling $350,000. These agreements had the economic effect of modifying the LIBOR-based variable interest rate on an equivalent amount of the Company s debt to fixed rates ranging from 4.05% to 4.70%, resulting in an overall weighted average effective interest rate of 5.83% on the hedged portion of the Company s Senior Secured Credit Facilities, including the term loan B margin of 1.50%. The swap agreements expire by September 30, 2010 and require quarterly interest payments. The Company estimates that approximately $5,600 of existing unrealized pre-tax losses in other comprehensive income at March 31, 2010 will be reclassified into income over the next two quarters.

The following table summarizes our derivative instruments as of March 31, 2010 and December 31, 2009:

	Interest rate swap liabilities			
	March 31, 2010		December 31, 2009	
Derivatives designated as hedging instruments	**Balance sheet location**	**Fair value**	**Balance sheet location**	**Fair value**
Interest rate swap agreements	Other current liabilities	$ 7,071	Other current liabilities	$ 10,792

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DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars and shares in thousands)

The following table summarizes the effects of our interest rate swap agreements for the three months ended March 31, 2010 and 2009:

Derivatives designated as cash flow hedges	Amount of gains (losses) recognized in OCI on interest rate swap agreements Three months ended March 31, 2010	2009	Location of (losses) gains reclassified from accumulated OCI into income	Amount of gains (losses) reclassified from accumulated OCI into income Three months ended March 31, 2010	2009
Interest rate swap agreements	$ (283)	$ (562)	Debt expense	$ (3,579)	$ (4,548)
Tax expense benefit (expense)	110	219		1,392	1,769
Total	$ (173)	$ (343)		$ (2,187)	$ (2,779)

Total comprehensive income for the three months ended March 31, 2010 was $127,228 including an increase to other comprehensive income for amounts reclassified into income, net of unrealized valuation loss on interest rate swaps of $2,014, net of tax, and an increase to other comprehensive income for unrealized valuation gains on investments, and the amounts reclassified into income of $214, net of tax.

Total comprehensive income for the three months ended March 31, 2009 was $110,502 including an increase to comprehensive income for amounts reclassified into income, net of unrealized valuation losses on interest rate swaps of $2,436, net of tax, and adjustments to other comprehensive income for unrealized losses on investments, net of amounts reclassified into income of ($208), net of tax.

As of March 31, 2010, the Company s interest rates were economically fixed on approximately 19% of its variable rate debt and approximately 59% of its total debt.

As a result of the swap agreements, the Company s overall weighted average effective interest rate on the Senior Secured Credit Facilities was 2.57%, based upon the current margins in effect of 1.50%, as of March 31, 2010.

The Company s overall weighted average effective interest rate during the first quarter of 2010 was 4.67% and as of March 31, 2010 was 4.66%.

As of March 31, 2010, the Company has undrawn revolving credit facilities totaling $250,000 of which approximately $52,000 was committed for outstanding letters of credit. In addition, the Company currently has undrawn revolving credit facilities totaling $2,500 associated with several of its joint ventures. These revolving credit facilities are typically guaranteed by DaVita Inc. or one of its wholly-owned operating subsidiaries based upon its proportionate ownership percentage.

5. Contingencies

The majority of the Company s revenues are from government programs and may be subject to adjustment as a result of: (1) examination by government agencies or contractors, for which the resolution of any matters raised may take extended periods of time to finalize; (2) differing interpretations of government regulations by

DAVITA INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

(dollars and shares in thousands)

different fiscal intermediaries or regulatory authorities; (3) differing opinions regarding a patient s medical diagnosis or the medical necessity of services provided; and (4) retroactive applications or interpretations of governmental requirements. In addition, the Company s revenues from commercial payors may be subject to adjustment as a result of potential claims for refunds, as a result of government actions or as a result of other claims by commercial payors.

Inquiries by the Federal Government

In December 2008, the Company received a subpoena for documents from the Office of Inspector General, U.S. Department of Health and Human Services, or OIG, relating to the pharmaceutical products Zemplar, Hectorol, Venofer, Ferrlecit and Epogen®, or EPO, as well as other related matters. The subpoena covers the period from January 2003 to the present. The Company has been in contact with the United States Attorney s Office, or U.S. Attorney s Office, for the Northern District of Georgia and the U.S. Department of Justice in Washington, DC, since November 2008 relating to this matter, and has been advised that this is a civil inquiry. On June 17, 2009, the Company learned that the allegations were made as part of a civil qui tam complaint filed by individuals and brought pursuant to the federal False Claims Act. The case remains under seal in the United States District Court for the Northern District of Georgia. The Company is cooperating with the inquiry and is producing the requested records. To the Company s knowledge, no proceedings have been initiated by the federal government against the Company at this time. Although the Company cannot predict whether or when proceedings might be initiated, or when these matters may be resolved, it is not unusual for investigations such as these to continue for a considerable period of time. Responding to the subpoena will continue to require management s attention and significant legal expense. Any negative findings could result in substantial financial penalties against the Company and exclusion from future participation in the Medicare and Medicaid programs.

In February 2007, the Company received a request for information from the OIG for records relating to EPO claims submitted to Medicare. In August 2007, the Company received a subpoena from the OIG seeking similar documents. The requested documents relate to services provided from 2001 to 2004 by a number of the Company s centers. The request and subpoena were sent from the OIG s offices in Houston and Dallas, Texas. The Company is cooperating with the inquiry and is producing the requested records. The Company has been in contact with the U.S. Attorney s Office for the Eastern District of Texas, which has stated that this is a civil inquiry related to EPO claims. On July 6, 2009, the United States District Court for the Eastern District of Texas lifted the seal on the civil qui tam complaint related to these allegations and the Company was subsequently served with a complaint by the relator. The Company believes that there is some overlap between this issue and the ongoing review of EPO utilization and claims by the U.S. Attorney s Office for the Eastern District of Missouri in St. Louis described below. To the Company s knowledge, no proceedings have been initiated by the federal government against the Company at this time. Although the Company cannot predict whether or when proceedings might be initiated or when these matters may be resolved, it is not unusual for investigations such as these to continue for a considerable period of time. Responding to these inquiries will continue to require management s attention and significant legal expense. Any negative findings could result in substantial financial penalties against the Company and exclusion from future participation in the Medicare and Medicaid programs.

In March 2005, the Company received a subpoena from the U.S. Attorney s Office for the Eastern District of Missouri in St. Louis. The subpoena requires production of a wide range of documents relating to the Company s operations, including documents related to, among other things, pharmaceutical and other services provided to patients, relationships with pharmaceutical companies, and financial relationships with physicians and joint ventures. The subpoena covers the period from December 1, 1996 through the present. In October 2005,

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the Company received a follow-up request for additional documents related to specific medical director and joint venture arrangements. In February 2006, the Company received an additional subpoena for documents, including certain patient records relating to the administration and billing of EPO. In May 2007, the Company received a request for documents related to durable medical equipment and supply companies owned and operated by the Company. The Company is cooperating with the inquiry and is producing the requested records. The subpoenas have been issued in connection with a joint civil and criminal investigation. It is possible that criminal proceedings may be initiated against the Company in connection with this inquiry. To the Company s knowledge, no proceedings have been initiated against the Company at this time. Although the Company cannot predict whether or when proceedings might be initiated or when these matters may be resolved, it is not unusual for investigations such as these to continue for a considerable period of time. Responding to the subpoenas will continue to require management s attention and significant legal expense. Any negative findings could result in substantial financial penalties against the Company, exclusion from future participation in the Medicare and Medicaid programs and criminal penalties.

The Company was recently advised by the U.S. Department of Justice that it is conducting a civil investigation into the Company s financial relationships with physicians. The Company has not received details as to the extent or scope of the inquiry but is expecting a subpoena in the near future. The Company intends to cooperate with the investigation just as it is cooperating with the U.S. Attorney s Offices with respect to each of the other inquiries as described above.

Other

The Company has received several notices of claims from commercial payors and other third parties related to historical billing practices and claims against DVA Renal Healthcare (formerly known as Gambro Healthcare) related to historical Gambro Healthcare billing practices and other matters covered by their 2004 settlement agreement with the Department of Justice and certain agencies of the U.S. government. At least one commercial payor has filed an arbitration demand against the Company, as described below, and additional commercial payors have threatened litigation. The Company intends to defend against these claims vigorously; however, the Company may not be successful and these claims may lead to litigation and any such litigation may be resolved unfavorably.

Several wage and hour claims have been filed against the Company in the Superior Court of California, each of which has been styled as a class action. In February 2007, June 2008, October 2008 and December 2008, the Company was served with five separate complaints, including two in October 2008, by various former employees, each of which alleges, among other things, that the Company failed to provide rest and meal periods, failed to pay compensation in lieu of providing such rest or meal periods, failed to pay the correct amount of overtime, failed to pay the rate on the wage statement, and failed to comply with certain other California Labor Code requirements. The Company has reached a settlement and release of all claims against it in connection with the complaints served in February 2007 and December 2008 and one of the complaints served in October 2008. The Company has fully funded the settlement which, pursuant to the terms of the settlement agreement, will result in a dismissal of the underlying court proceedings against it. The overall settlement amount was not material. The Company intends to vigorously defend against the remaining claims and to vigorously oppose the certification of the remaining matters as class actions.

In October 2007, the Company was contacted by the Attorney General s Office for the State of Nevada. The Attorney General s Office informed the Company that it was conducting a civil and criminal investigation of the

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Company s operations in Nevada and that the investigation related to the billing of pharmaceuticals, including EPO. In February 2008, the Attorney General s Office informed the Company that the civil and criminal investigation has been discontinued. The Attorney General s Office further advised the Company that Nevada Medicaid intends to conduct audits of end stage renal disease (ESRD) dialysis providers in Nevada, including the Company, and that such audits will relate to the issues that were the subjects of the investigation. To the Company s knowledge, no court proceedings have been initiated against the Company at this time. Any negative audit findings could result in a substantial repayment by the Company.

In August 2005, Blue Cross/Blue Shield of Louisiana filed a complaint in the United States District Court for the Western District of Louisiana against Gambro AB, DVA Renal Healthcare (formerly known as Gambro Healthcare) and related entities. The plaintiff sought to bring its claims as a class action on behalf of itself and all entities that paid any of the defendants for health care goods and services from on or about January 1991 through at least December 2004. The complaint alleged, among other things, damages resulting from facts and circumstances underlying Gambro Healthcare s 2004 settlement agreement with the Department of Justice and certain agencies of the U.S. government. In March 2006, the case was dismissed and the plaintiff was compelled to seek arbitration to resolve the matter. In November 2006, the plaintiff filed a demand for class arbitration against the Company and DVA Renal Healthcare. The Company intends to vigorously defend against these claims. The Company also intends to vigorously oppose the certification of this matter as a class action. At this time, the Company cannot predict the ultimate outcome of this matter or the potential range of damages, if any.

In June 2004, Gambro Healthcare was served with a complaint filed in the Superior Court of California by one of its former employees who worked for its California acute services program. The complaint, which is styled as a class action, alleges, among other things, that DVA Renal Healthcare failed to provide overtime wages, defined rest periods and meal periods, or compensation in lieu of such provisions and failed to comply with certain other California Labor Code requirements. The Company intends to vigorously defend against these claims. The Company also intends to vigorously oppose the certification of this matter as a class action. At this time, the Company cannot predict the ultimate outcome of this matter.

In addition to the foregoing, the Company is subject to claims and suits, including from time to time, contractual disputes and professional and general liability claims, as well as audits and investigations by various government entities, in the ordinary course of business. The Company believes that the ultimate resolution of any such pending proceedings, whether the underlying claims are covered by insurance or not, will not have a material adverse effect on its financial condition, results of operations or cash flows.

6. Investments in debt and equity securities

Based on the Company s intentions and strategy involving investments in debt and equity securities, the Company classifies certain debt securities as held-to-maturity and records them at amortized cost. Equity securities that have readily determinable fair values and certain other debt securities classified as available for sale are recorded at fair value.

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The Company s investments consist of the following:

	March 31, 2010			December 31, 2009		
	Held to maturity	Available for sale	Total	Held to maturity	Available for sale	Total
Certificates of deposit, money market funds and U.S. treasury notes due within one year	$ 21,707	$	$ 21,707	$ 25,275	$	$ 25,275
Investments in mutual funds		8,784	8,784		8,816	8,816
	$ 21,707	$ 8,784	$ 30,491	$ 25,275	$ 8,816	$ 34,091
Short-term investments	$ 21,707	$ 1,200	$ 22,907	$ 25,275	$ 1,200	$ 26,475
Long-term investments		7,584	7,584		7,616	7,616
	$ 21,707	$ 8,784	$ 30,491	$ 25,275	$ 8,816	$ 34,091

The cost of the certificates of deposit, money market funds and U.S. treasury notes at March 31, 2010 and December 31, 2009 approximates their fair value. As of March 31, 2010 and December 31, 2009, the available for sale investments included $145 and $(205), respectively, of gross pre-tax unrealized gains (losses). During the three months ended March 31, 2010, the Company recorded gross pre-tax unrealized gains of $200, after tax, in other comprehensive income associated with changes in the fair value of these investments. During the three months ended March 31, 2010, the Company sold equity securities in mutual funds for net proceeds of $880, and recognized a pre-tax loss of $22, or $14 after tax, that was previously recorded in other comprehensive income. The pre-tax loss is included in other income.

As of March 31, 2010, investments totaling approximately $18,500 classified as held to maturity are investments used to maintain certain capital requirements of the special need plans of VillageHealth, which is a wholly-owned subsidiary of the Company. As of December 31, 2009, the Company discontinued the VillageHealth special needs plans and is in the process of paying out all incurred claims. The Company expects to liquidate these investments as soon as all of the claims are paid and the various state regulatory agencies approve the release of these investments. The investments in mutual funds classified as available for sale are held in trust to fund existing obligations associated with several of the Company s non-qualified deferred compensation plans.

7. Fair value of financial instruments

The Company measures the fair value of certain assets, liabilities and noncontrolling interests subject to put provisions based upon certain valuation techniques that include observable or unobservable inputs and assumptions that market participants would use in pricing these assets, liabilities and commitments. The Company also has classified certain assets, liabilities and noncontrolling interests subject to put provisions that are measured at fair value into the appropriate fair value hierarchy levels.

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The following table summarizes the Company s assets and liabilities measured at fair value on a recurring basis as of March 31, 2010:

	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets				
Available for sale securities	$ 8,784	$ 8,784	$	$
Liabilities				
Interest rate swap agreements	$ 7,071	$	$ 7,071	$
Temporary equity				
Noncontrolling interests subject to put provisions	$ 350,485	$	$	$ 350,485

The available for sale securities represent investments in various open-ended registered investment companies, or mutual funds, and are recorded at fair value based upon the quoted market prices as reported by each mutual fund. See Note 6 to the condensed consolidated financial statements for further discussion.

The interest rate swap agreements are recorded at fair value based upon valuation models and a variety of techniques as reported by various broker dealers that are based upon relevant observable market inputs such as current interest rates, forward yield curves, and other credit and liquidity market conditions. The Company does not believe the ultimate amount that could be realized upon settlement of these interest rate swap agreements would be materially different than the fair values as currently reported. See Note 4 to the condensed consolidated financial statements for further discussion.

See Note 8 to the condensed consolidated financial statements for a discussion of the Company s methodology for estimating the fair value of noncontrolling interests subject to put obligations.

The Company has other financial instruments in addition to the above that consist primarily of cash, accounts receivable, notes receivable, accounts payable, other accrued liabilities, and debt. The balances of the non-debt financial instruments are presented in the condensed consolidated financial statements at March 31, 2010 at their approximate fair values due to the short-term nature of their settlements. Borrowings under the Company s Senior Secured Credit Facilities totaled $1,837,125 as of March 31, 2010 and the fair value was $1,814,161 based upon quoted market prices. The fair value of the Company s senior and senior subordinated notes was approximately $1,775,875 at March 31, 2010, based upon quoted market prices, as compared to the carrying amount of $1,750,000.

8. Noncontrolling interests subject to put provisions and other commitments

The Company has potential obligations to purchase the noncontrolling interests held by third parties in several of its joint ventures and non-wholly-owned subsidiaries. These obligations are in the form of put provisions and are exercisable at the third-party owners discretion within specified periods as outlined in each specific put provision. If these put provisions were exercised, the Company would be required to purchase the third-party owners noncontrolling interests at either the appraised fair market value or a predetermined multiple of earnings or cash flow attributable to the noncontrolling interests put to the Company, which is intended to

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approximate fair value. The methodology the Company uses to estimate the fair values of noncontrolling interests subject to put provisions assumes either the higher of a liquidation value of net assets or an average multiple of earnings, based on historical earnings, patient mix and other performance indicators, as well as other factors. The estimated fair values of the noncontrolling interests subject to put provisions can fluctuate and the implicit multiple of earnings at which these noncontrolling interests obligations may be settled will vary significantly depending upon market conditions including potential purchasers access to the capital markets, which can impact the level of competition for dialysis and non-dialysis related businesses, the economic performance of these businesses and the restricted marketability of the third-party owners noncontrolling interests. The amount of noncontrolling interests subject to put provisions that contractually employ a predetermined multiple of earnings rather than fair value are immaterial.

Additionally, the Company has certain other potential commitments to provide operating capital to several dialysis centers that are wholly-owned by third parties or centers in which the Company owns an equity investment as well as to physician-owned vascular access clinics that the Company operates under management and administrative services agreements of approximately $6,200.

Certain consolidated joint ventures are contractually scheduled to dissolve after terms ranging from ten to fifty years. Accordingly, the noncontrolling interests in these joint ventures are considered mandatorily redeemable instruments for which the classification and measurement requirements have been indefinitely deferred. Future distributions upon dissolution of these entities would be valued below the related noncontrolling interest carrying balances in the condensed consolidated balance sheet.

9. Income taxes

As of March 31, 2010, the Company s total liability for unrecognized tax benefits relating to tax positions that do not meet the more-likely-than-not threshold is $18,718, of which $12,286 would impact the Company s effective tax rate if recognized. The balance represents a decrease of $11,975 from the December 31, 2009 balance, primarily due to a tax accounting method change initiated during the quarter ending March 31, 2010. This decrease did not impact the Company s effective tax rate. It is reasonably possible that $6,433 of unrecognized tax benefits may be recognized within the next 12 months, primarily related to tax accounting method changes.

The Company recognizes accrued interest and penalties related to unrecognized tax benefits in its income tax expense. At March 31, 2010 and December 31, 2009, the Company had approximately $4,243 and $3,226, respectively, accrued for interest and penalties related to unrecognized tax benefits, net of federal tax benefits.

10. Segment reporting

The Company operates principally as a dialysis and related lab services business but also operates other ancillary services and strategic initiatives. These ancillary services and strategic initiatives consist of pharmacy services, infusion therapy services, disease management services, vascular access services, ESRD clinical research programs and physician services. For internal management reporting, the dialysis and related lab services business and each of the ancillary services and strategic initiatives have been defined as separate operating segments by management as separate financial information is regularly produced and reviewed by the Company s chief operating decision maker in making decisions about allocating resources and assessing financial results. The Company s chief operating decision maker is its Chief Executive Officer. The dialysis and

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related lab services business qualifies as a separately reportable segment and all of the other ancillary services and strategic initiatives operating segments have been combined and disclosed in the other segments category.

The Company s operating segment financial information is prepared on an internal management reporting basis that the Chief Executive Officer uses to allocate resources and analyze the performance of operating segments. For internal management reporting, segment operations include direct segment operating expenses with the exception of stock-based compensation expense and equity investment income (loss).

The following is a summary of segment revenues, segment operating income (loss), and a reconciliation of segment income to consolidated income before income taxes:

	Three months ended March 31,	
	2010	**2009**
Segment revenues:		
Dialysis and related lab services [1]	$ 1,478,424	$ 1,376,563
Other Ancillary services and strategic initiatives	80,994	71,077
Consolidated revenues	$ 1,559,418	$ 1,447,640
Segment operating income (loss):		
Dialysis and related lab services	$ 252,562	$ 236,952
Other Ancillary services and strategic initiatives	(2,008)	(5,321)
Total segment income	$ 250,554	$ 231,631
Reconciliation of segment income to consolidated income before income taxes:		
Stock-based compensation	$ (10,233)	$ (11,009)
Equity investment income (loss)	2,345	(18)
Consolidated operating income	242,666	220,604
Debt expense	(44,583)	(48,301)
Other income	831	754
Consolidated income before income taxes	$ 198,914	$ 173,057

(1) Includes management fees related to providing management and administrative services to dialysis centers that are wholly-owned by third parties or centers in which the Company owns an equity investment.

Depreciation and amortization expense for the dialysis and related lab services for the three months ended March 31, 2010 was $55,817, and was $1,651 for the ancillary services and strategic initiatives.

Depreciation and amortization expense for the dialysis and related lab services for the three months ended March 31, 2009 was $55,374, and was $1,749 for the ancillary services and strategic initiatives.

Summary of assets by segment is as follows:

	March 31, 2010	December 31, 2009
Segment assets		
Dialysis and related lab services	$ 7,471,859	$ 7,334,235
Other Ancillary services and strategic initiatives	219,859	224,001
Consolidated assets	$ 7,691,718	$ 7,558,236

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