GENESIS HEALTH VENTURES INC /PA
Form 10-Q
February 12, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended December 31, 2002
or
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from __________________ to __________________

Commission File Number: 00033217

GENESIS HEALTH VENTURES, INC.
(Exact name of registrant as specified in its charter)

Pennsylvania	**06-1132947**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

101 East State Street
Kennett Square, Pennsylvania 19348
(Address, including zip code, of principal executive offices)

(610) 4446350
(Registrants telephone number including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES __X__ NO ___

Indicate by check mark whether the registrant is an accelerated filer (as defined by Rule 12b2 of the Act).

YES __X (1)__ NO ___

(1) The registrant meets the definition of accelerated filer (as defined by Rule 12b-2 of the Act). However, the registrant notes that the phase-in period for accelerated deadlines of quarterly and annual reports will begin for reports filed by companies that meet the definition of accelerated filer as of the end of the their first fiscal year ending after December 15, 2002. Accordingly, such rules do not currently apply to the registrant.

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPCY PROCEEDINGS DURING THE PRECEDING FIVE YEARS.

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

YES ___X___ NO___

APPLICABLE ONLY TO CORPORATE ISSUERS.

As of February 7, 2003: 41,150,164 shares of the registrant's common stock were outstanding and 549,021 shares are to be issued in connection with the registrant's joint plan of reorganization confirmed by the Bankruptcy Court on September 20, 2001.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

As used herein, unless the context otherwise requires, "Genesis," the "Company," "we," "our" or "us" refers to Genesis Health Ventures, Inc. and our subsidiaries.

Statements made in this report, and in our other public filings and releases, which are not historical facts contain "forward-looking" statements (as defined in the Private Securities Litigation Reform Act of 1995) that involve risks and uncertainties and are subject to change at any time. These forward-looking statements may include, but are not limited to:

- certain statements in "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the notes to our unaudited condensed consolidated financial statements, such as our ability to meet our liquidity needs, scheduled debt and interest payments, and expected future capital expenditure requirements; the expected effects of government regulation on reimbursement for services provided; our ability to successfully implement our strategic objectives and achieve certain performance improvement initiatives within our pharmacy services segment; our ability to improve current pharmacy operating income; the duration we expect to incur strategic planning, severance and other related costs; the expected reduction in medical supply revenues; the expected costs in fiscal 2003 and the foreseeable future; estimates in our critical accounting policies including, such as our allowance for doubtful accounts, our anticipated impact of long-lived asset impairments and our ability to provide for loss reserves for self-insured programs; the expected decline in interest expense; and our ability to maintain restricted investments in marketable securities representing the level of outstanding insurance losses we expect to pay;

The forward-looking statements involve known and unknown risks, uncertainties and other factors that are, in some cases, beyond our control. You are cautioned that these statements are not guarantees of future performance and that actual results and trends in the future may differ materially.

Factors that could cause actual results to differ materially include, but are not limited to the following:

- changes in the reimbursement rates or methods of payment from Medicare and Medicaid, or the implementation of other measures to reduce the reimbursement for our services;
- the expiration of enactments providing for additional governmental funding;
- changes in pharmacy legislation and payment formulas;
- the impact of federal and state regulations;
- changes in payor mix and payment methodologies;
- further consolidation of managed care organizations and other third party payors;
- competition in our businesses;
- an increase in insurance costs and potential liability for losses not covered by, or in excess of, our insurance;
- competition for qualified staff in the healthcare industry;
- our ability to control operating costs and generate sufficient cash flow to meet operational and financial requirements;
- an economic downturn or changes in the laws affecting our business in those markets in which we operate;
- the impact of our reliance on one pharmacy supplier to provide a significant portion of our pharmacy products;

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In addition to these factors and any risks and uncertainties specifically identified in the text surrounding forward-looking statements, any statements in this report or the reports and other documents filed by us with the SEC that warn of risks or uncertainties associated with future results, events or circumstances also identify factors that could cause actual results to differ materially from those expressed in or implied by the forward-looking statements.

All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We do not undertake any obligation to release publicly any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except as may be required under applicable securities law.

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

GENESIS HEALTH VENTURES, INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2002 AND SEPTEMBER 30, 2002
(IN THOUSANDS)

	December 31, 2002	September 30, 2002
Assets:		
Current assets:		
Cash and equivalents	$ 94,174	$ 148,030
Restricted investments in marketable securities	15,574	15,074
Accounts receivable, net	376,181	369,969
Inventory	66,008	64,734
Prepaid expenses and other current assets	65,175	47,850
Assets held for sale	22,295	46,134
Total current assets	639,407	691,791
Assets held for sale	38,875	—
Property, plant and equipment, net	775,438	795,928
Restricted investments in marketable securities	79,666	71,073
Other long-term assets	46,233	51,042
Investments in unconsolidated affiliates	14,210	14,143
Identifiable intangible assets, net	26,310	25,795
Goodwill	341,822	339,723
Total assets	$1,961,961	$1,989,495
Liabilities and Shareholders' Equity:		
Current liabilities:		
Current installments of long-term debt	$ 33,104	$ 40,744
Accounts payable and accrued expenses	190,080	202,041
Total current liabilities	223,184	242,785
Long-term debt	613,377	648,939
Deferred income taxes	41,732	37,191
Self-insurance liability reserves	51,847	42,019
Other long-term liabilities	48,822	48,989
Minority interests	10,020	10,684
Redeemable preferred stock, including accrued dividends	45,449	44,765
Commitments and contingencies		

Shareholders equity	927,530	914,123
Total liabilities and shareholders equity	$1,961,961	$1,989,495

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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GENESIS HEALTH VENTURES, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
THREE MONTHS ENDED DECEMBER 31, 2002 AND 2001
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	Three Months Ended December 31, 2002	Three Months Ended December 31, 2001
Net revenues:		
Inpatient services	$ 330,751	$ 323,045
Pharmacy services	295,067	272,605
Other revenue	43,693	39,981
Total net revenues	669,511	635,631
Operating expenses:		
Salaries, wages and benefits	290,270	268,067
Cost of sales	186,752	172,099
Other operating expenses	134,204	134,852
Strategic planning, severance and other related costs	7,245	—
Net gain from break-up fee and other settlements	(12,306)	—
Depreciation and amortization expense	16,671	15,128
Lease expense	7,162	6,919
Interest expense	11,405	11,730
Income before income tax expense, equity in net income of unconsolidated affiliates and minority interests	28,108	26,836
Income tax expense	10,961	10,466
Income before equity in net income of unconsolidated affiliates and minority interests	17,147	16,370
Equity in net income of unconsolidated affiliates	147	615
Minority interests	(1,115)	(157)
Income from continuing operations before preferred stock dividends	16,179	16,828
Preferred stock dividends	683	630

Income from continuing operations	15,496	16,198
Loss from discontinued operations, net of taxes	(3,559)	(599)
Net income attributed to common shareholders	$ 11,937	$ 15,599
Per Common Share Data:		
Basic:		
Income from continuing operations	$ 0.37	$ 0.39
Loss from discontinued operations	(0.09)	(0.01)
Net income	$ 0.29	$ 0.38
Weighted average shares	41,457,531	41,037,500
Diluted:		
Income from continuing operations	$ 0.37	$ 0.39
Loss from discontinued operations	(0.08)	(0.01)
Net income	$ 0.29	$ 0.38
Weighted average shares - income from continuing operations	43,711,802	43,163,914
Weighted average shares - net income	41,497,591	43,163,914

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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GENESIS HEALTH VENTURES, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED DECEMBER 31, 2002 AND 2001
(IN THOUSANDS)

	Three Months Ended December 31, 2002	Three Months Ended December 31, 2001
Cash flows from operating activities:		
Net income attributed to common shareholders	$ 11,937	$ 15,599
Net charges included in operations not requiring funds	30,372	35,010
Changes in assets and liabilities:		
Accounts receivable	(16,825)	(6,329)
Accounts payable and accrued expenses	(11,119)	28,103
Other, net	(1,025)	1,295
Net cash provided by operating activities before debt restructuring and reorganization costs	13,340	73,678
Cash paid for debt restructuring and reorganization costs	(331)	(25,974)
Net cash provided by operating activities	13,009	47,704
Cash flows from investing activities:		
Capital expenditures	(12,829)	(10,821)
Net purchases of restricted marketable securities	(9,093)	(5,669)
Acquisition of rehabilitation services business	(5,436)	—
Sale (purchase) of eldercare assets	1,358	(10,453)
Other	504	(2,354)
Net cash used in investing activities	(25,496)	(29,297)
Cash flows from financing activities:		
Repayment of long-term debt and payment of sinking fund requirements	(43,369)	(23,469)
Proceeds from issuance of long-term debt	—	33,000
Other	2,000	—
Net cash (used in) provided by financing activities	(41,369)	9,531

Net (decrease) increase in cash and equivalents	$ (53,856)	$ 27,938
Cash and equivalents:		
Beginning of period	148,030	32,139
End of period	$ 94,174	$ 60,077
Supplemental cash flow information:		
Interest paid	$ 12,792	$ 11,369
Income taxes paid, net	4,011	633
Non-cash financing activities:		
Capital leases	1,112	695

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements.

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Genesis Health Ventures, Inc. and Subsidiaries
Notes To Unaudited Condensed Consolidated Financial Statements

1. Business

Genesis Health Ventures, Inc. was incorporated in May 1985 as a Pennsylvania corporation. As used herein, unless the context otherwise requires, "Genesis," or the "Company," refers to Genesis Health Ventures, Inc. and its subsidiaries.

Genesis is a leading provider of healthcare and support services to the elderly. The Company's operations are comprised of two primary business segments, inpatient services and pharmacy services. These segments are complemented by an array of other service capabilities. See note 3 "Strategic Planning, Severance and Other Related Costs".

Genesis provides inpatient services through skilled nursing and assisted living centers primarily located in the eastern United States. Genesis currently owns, leases, manages or jointly-owns 254 eldercare centers with 30,704 beds, of which 18 centers having 1,922 beds have been identified as either held for sale or discontinued operations. See note 8 "Assets Held for Sale and Discontinued Operations". Genesis includes the revenues of its owned and leased centers in inpatient service revenues in the unaudited consolidated statements of operations. Management fees earned from the Company's managed and / or jointly-owned eldercare centers are included in other revenues in the unaudited consolidated statements of operations.

Genesis provides pharmacy services nationwide through its NeighborCare® integrated pharmacy operation that serves approximately 248,000 institutional beds in long-term care settings. The Company also operates 31 community-based retail pharmacies.

Genesis also provides rehabilitation services, diagnostic services, respiratory services, hospitality services, group purchasing services and healthcare consulting services, the revenues for which are included in other revenues in the unaudited consolidated statements of operations.

2. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's annual report on Form 10-K for the fiscal year ended September 30, 2002.

The accompanying condensed consolidated financial statements are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited condensed consolidated financial statements include all necessary adjustments consisting of normal recurring accruals and adjustments for a fair presentation of the financial position and results of operations for the periods presented.

The Company has made a number of estimates relating to the reporting of assets and liabilities, revenues and expenses and the disclosure of contingent assets and liabilities to prepare these unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Some of the more significant estimates impact accounts receivable, long-lived assets and loss reserves for self-insurance programs. Actual results could differ from those estimates.

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3. Strategic Planning, Severance and Other Related Costs

Genesis has incurred costs that are directly attributable to the Company's long-term objective of transforming to a pharmacy-based business. These costs are expected to continue through the end of our second fiscal quarter of 2003 and are segregated in the unaudited consolidated statements of operations as "strategic planning, severance and other related costs". Details of these costs at December 31, 2002 follow (in thousands):

	Accrued at September 30,	Three Months Ended December 31, 2002		Accrued at December 31,
	2002	Provision	Paid	2002
Severance and related costs	$ 1,100	$ 4,867	$ 4,363	$ 1,604
Strategic consulting costs	621	2,378	2,533	466
Total	$ 1,721	$ 7,245	$ 6,896	$ 2,070

4. Certain Significant Risks and Uncertainties

The Company receives revenues from Medicare, Medicaid, private insurance, self-pay residents, other third party payors and long-term care facilities which utilize our pharmacy and other specialty medical services. The healthcare industry is experiencing the effects of the federal and state governments' trend toward cost containment, as government and other third party payors seek to impose lower reimbursement and utilization rates and negotiate reduced payment schedules with providers. These cost containment measures, combined with the increasing influence of managed care payors and competition for patients, have resulted in constrained rates of reimbursement for services provided by the Company.

The Medicaid and Medicare programs are highly regulated. The failure of the Company or its customers to comply with applicable reimbursement regulations could adversely affect the Company's business. The Company monitors its receivables from third party payor programs and reports such revenues at the net realizable value expected to be received.

On December 15, 2000, Congress passed the Benefits Improvement Protection Act that increased the nursing component of federal prospective payment system's rates by approximately 16.7% for the period from April 1, 2001 through September 30, 2002. The legislation also changed the 20% add-on to 3 of the 14 rehabilitation resource utilization group categories to a 6.7% add-on to all 14 rehabilitation resource utilization group categories beginning April 1, 2001. The Medicare Part B consolidated billing provision of the Balance Budget Refinement Act was repealed except for Medicare Part B therapy services and the moratorium on the $1,500 therapy caps was extended through calendar year 2002. These changes had a positive impact on operating results.

A number of provisions of the Balanced Budget Refinement Act and the Benefits Improvement and Protection Act enactments, providing additional funding for Medicare participating skilled nursing facilities, expired on September 30, 2002. The expiration of these provisions has reduced Genesis' Medicare per diems per beneficiary, on average, by $34, resulting in reduced revenue of approximately $9.3 million in the Company's first quarter of fiscal 2003 (the Medicare Cliff). For Federal fiscal year 2003 the Centers for Medicare and Medicaid Services used their discretionary authority to continue the payment add-ons. The recently released proposed Federal Budget for fiscal year 2004 indicates that the Centers for Medicare and Medicaid Services will extend the add-ons described in the previous paragraph for the coming year. It is uncertain as to whether as part of the rule-making process the agency will propose changes in how the add-ons are applied. Proposed rules are normally released in late April with a 60-day public comment period. By law, final rules for coming fiscal year must be issued by August 1. Effective October 1, 2002, Medicare rates adjusted for the Medicare Cliff were increased by a 2.6% annual market basket adjustment. For Genesis, the net impact of these provisions is estimated to adversely impact annual revenue and operating income from continuing operations beginning October 1, 2002 by approximately $28 million.

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There are additional provisions in the Medicare statute affecting pharmacy, rehabilitation therapy, diagnostic services and the payment for services in other health settings. There are two issues in particular that could have measurable negative impact, practitioner fee schedules and caps on Medicare Part B therapies. Absent Congressional action, the formula driven payment structure for calendar year 2003 physician and non‑physician fee schedules will be reduced by 4.4%. This reduction affects not only doctors, but also payment for most professional practitioners including licensed rehabilitation professionals. Centers for Medicare and Medicaid Services has delayed the implementation of the fiscal year 2003 fee schedules to March 1, 2003 providing Congress time to address the fee schedule reduction. Legislation has passed the Senate preventing the reduction. While the measure has the support of the White House and key legislators, passage is still not assured. Effective January 1, 2003, the moratorium on implementing payment caps on therapy services expired. The Centers for Medicare and Medicaid Services has issued instructions indicating that the agency is not prepared to apply the therapy limit at this time, and that any implementation would be prospective from the date that instructions are effective.

Pharmacy coverage and cost containment are important policy debates at both the federal and state levels. One of the most contentious issues before the 107th Congress was legislation expanding coverage under Medicare for outpatient pharmaceutical services. In June, 2002 the House of Representatives passed a comprehensive measure that would have expanded coverage administered by pharmacy benefit managers. The Senate deadlocked in its deliberations. Medicare pharmacy coverage was an important issue during the 2002 mid‑term Congressional elections and, therefore, it is not unreasonable to expect that the 108th Congress will resume consideration of a benefit expansion. In both his State of the Union Address and his budget message, the President has highlighted his appeal for Medicare modernization and enactment of a broader Medicare outpatient drug benefit. Transforming Medicare was a major theme of the President's State of the Union address and his proposed fiscal year 2004 budget.

Many of these alternative payment provisions are expected to be considered during the 108th Congress either as part of consideration of the "Medicare Modernization" initiative or as freestanding legislation. It is premature to predict what actions the Congress will enact. Absent additional legislative authority, the Centers for Medicare and Medicaid Services has certain discretionary authority to adjust drug pricing. Effective January 2003, Centers for Medicare and Medicaid Services implemented a directive creating a single national calculation of "average wholesale price" for Medicare purchased drugs and biologicals.

A number of states have enacted or are considering containment initiatives affecting pharmacy services. Many have focused on reducing what the state Medicaid program will pay for drug acquisition costs. Most states have lowered payment to a negative percentage of average wholesale price. Some have attempted to impose more stringent pricing standards. Institutional pharmacies are often paid a dispensing fee over and above the payment for the drug. To the extent that changes in the payment for drugs are not accompanied by an increase in the dispensing fee, margins could erode. Some states have explored efforts to restrict utilization (preferred drug lists, prior‑authorization, formularies). A few states have attempted to extend the preferred Medicaid pricing to all Medicare beneficiaries.

The recent economic downturn is having a detrimental affect on state revenues in most jurisdictions. Budget shortfalls range from 4‑5% of outlays upwards to 20% of outlays in a handful of states. Historically these budget pressures have translated into reductions in state spending. Given that Medicaid outlays are a significant component of state budgets, we expect continuing cost containment pressures on Medicaid outlays for nursing homes and pharmacy services in the states in which we operate. State‑specific details are just emerging as state legislatures begin the tasks of approving state budgets.

The plight of state governments has helped to elevate issues related to Medicaid onto the national agenda. During the 107th Congress, the U.S. Senate passed legislation providing states with a temporary increase in the Federal Matching Assistance Percentage. This legislation was not passed, however, it has been reintroduced in both the U.S. Senate and the U.S. House of Representatives. In his proposed federal budget for fiscal year 2004, the President offered modest additional fiscal support and advanced several ideas for revising the program. The 108th Congress is expected to consider an array of Medicaid reform proposals.

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It is not possible to quantify fully the effect of potential legislative or regulatory changes, the administration of such legislation or any other governmental initiatives on Genesis business. Accordingly, there can be no assurance that the impact of these changes or any future healthcare legislation will not further adversely affect Genesis business. There can be no assurance that payments under governmental and private third party payor programs will be timely, will remain at levels comparable to present levels or will, in the future, be sufficient to cover the costs allocable to patients eligible for reimbursement pursuant to such programs. Genesis financial condition and results of operations may be affected by the reimbursement process, which in the healthcare industry is complex and can involve lengthy delays between the time that revenue is recognized and the time that reimbursement amounts are settled.

5. Long Term Debt

Long term debt at December 31, 2002 and September 30, 2002 consists of the following (in thousands):

	December 31, 2002	September 30, 2002
Secured debt		
Senior Credit Facility		
Term Loan	$ 261,484	$ 281,575
Delayed Draw Term Loan	75,585	79,239
Total Senior Credit Facility	337,069	360,814
Senior Secured Notes	240,176	242,602
Mortgage and other secured debts	69,236	86,267
Total debt	646,481	689,683
Less:		
Current installments of long-term debt	(33,104)	(40,744)
Long-term debt	$ 613,377	$ 648,939

The Senior Credit Facility contains a provision requiring prepayment of amounts determined to be excess cash flow calculated as a percentage of operating profits, after capital investments and debt repayments. Of the amount determined as excess cash flow, 75% is to be paid to our senior lenders in the form of a mandatory prepayment by December 31st of each year. During the quarter ended December 31, 2002, the Company prepaid $23.8 million of debt under the Senior Credit Facility pursuant to the excess cash flow recapture provisions.

During the quarter ended December 31, 2002, the Company satisfied $16 million of mortgage debt associated with three eldercare properties resulting in a gain on the early extinguishment of debt of $1.1 million. This gain was reflected in the unaudited consolidated statements of operations under net gain from break up fee and other settlements.

The Senior Credit Facility agreement requires the Company to use a portion of the proceeds from the sale of certain assets to either repay Senior Credit Facility debt or to reinvest in similar assets. See note 15 Subsequent Event.

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6. Earnings (Loss) Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per share for the current quarter and the same period last year (in thousands, except per share data):

	2002	2001
Earnings (loss) used in computation:		
Income from continuing operations — basic computation	$ 15,496	$ 16,198
Elimination of preferred stock dividend requirements upon assumed conversion of preferred stock	683	630
Income from continuing operations — diluted computation	$ 16,179	$ 16,828
Loss discontinued operations — basic and diluted computation	$ (3,559)	$ (599)
Net income attributed to common shareholders — basic computation	$ 11,937	$ 15,599
Elimination of preferred stock dividend requirements upon assumed conversion of preferred stock	—	630
Net income — diluted computation	$ 11,937	$ 16,229
Shares used in computation:		
Weighted average shares outstanding — basic computation	41,458	41,038
Assumed conversion of preferred stock	2,214	2,126
Contingent consideration related to an acquisition	40	—
Weighted average shares outstanding — diluted computation, income from continuing operations and loss from discontinued operations	43,712	43,164
Less assumed conversion of preferred stock	(2,214)	—
Weighted average shares outstanding — diluted computation, net income attributed to common shareholders	41,498	43,164
Earnings per common share:		
Basic:		
Income from continuing operations	$ 0.37	$ 0.39
Loss from discontinued operations	(0.09)	(0.01)

Net income attributed to common shareholders	0.29