

1st Quarter Fiscal 2010 Earnings Conference Remarks

James W. Wiltz
President & Chief Executive Officer

- Good morning and thanks for participating in our first quarter conference call.
- Joining me today is Steve Armstrong, our executive vice president and chief financial officer.
- We will be pleased to take your questions at the conclusion of our remarks.
- Since Regulation FD prohibits us from providing investors with any earnings guidance unless we release that information simultaneously, we reiterated our previously-issued annual financial guidance for 2010 in our press release earlier this morning.
- Our guidance is subject to a number of risks and uncertainties that could cause Patterson's actual results to vary from our forecasts.
- These risks and uncertainties are discussed in detail in our Annual Report on Form 10-K and our other SEC filings, and we urge you to review this material.
- Turning now to our first quarter results, we believe Patterson performed reasonably well amid a very challenging economic environment.
- Consolidated sales of \$789.6 million were up 6% from \$743.9 million in the first quarter of 2009.
- The CEREC line of dental CAD/CAM products performed well during the quarter, as did our veterinary segment.
- Dental, veterinary and medical acquisitions transacted over the past 12 months accounted for most of our first quarter sales growth.
- The positive impact of acquisitions was partly offset by negative currency adjustments on the revenues of our foreign operations.
- We reported earnings of \$45.1 million or \$0.38 per diluted share, compared to \$46 million or \$0.39 per diluted share in the first quarter of 2009.
- In our last conference call, we spoke about a number of cost control measures that we began implementing during the second half of fiscal 2009.
- We took an additional step in this year's first quarter by enacting company-wide salary reductions.
- As a result of these measures, we have streamlined our overall cost structure and slowed our expense growth, which benefited our first quarter earnings.
- Total operating expenses were up modestly in the first quarter, primarily due to acquisition-related costs, but we expect to more fully leverage the expenses of our acquisitions going forward.
- Turning now to a brief review of our business unit performances, sales of Patterson Dental, our largest business, declined 2% in the first quarter to \$511 million.
- Within Patterson Dental, internal sales of consumable dental supplies and printed office products were down 1% from last year's first quarter, or 2% after the impact of foreign currency adjustments, net of acquisitions.
- We feel that consumables sales held up relatively well during this period, although many patients continued to defer higher-level and discretionary services for economy-related reasons.
- Later in this call, Steve will discuss two additional items that negatively affected the year-over-year comparability of our consumable supply business.
- The impact of the recession was particularly evident on sales of such basic dental equipment as chairs, units and lights, which declined 16% from the year-earlier period.
- However, dental practitioners continued investing in new-technology equipment at higher levels.
- Sales of CEREC® dental restorative systems rose 84%, while sales of digital x-ray systems and related software gained 16%.
- As we have said previously, we believe the recession is causing many dentists to limit their investments to equipment with rapid rates of return.
- New technology products, including CEREC and digital x-ray systems, meet this return on investment requirement.
- We believe the strong increase in first quarter CEREC sales also signals the growing market acceptance of CEREC's advanced CAD/CAM technology.

- This trend, which has gained momentum over the past two years, has been driven by new product introductions that have further strengthened CEREC's industry-leading position as well as our more focused sales effort.
- We believe this combination of factors has the potential to continue generating solid levels of CEREC sales.
- We also are encouraged by the strong first quarter sales of digital radiography systems and related software.
- Last year, we implemented several changes to Patterson Dental's operating model to, among other things, strengthen sales of digital products.
- We believe these changes have started working as planned.
- In addition, I want to mention that sales of Dolphin 3D imaging and practice management software are meeting our forecasted levels, which represents another positive for our focus on new technology products.
- Sales of Webster Veterinary increased 37% in the first quarter of 2010 to \$169.2 million, due primarily to the Columbus Serum acquisition.
- Excluding the impact of Columbus Serum, veterinary sales were up 8%, reflecting higher volumes of veterinary care for companion-pets, following several quarters of reduced patient activity.
- However, many veterinary practices are continuing to defer equipment purchases in view of the weak economy.
- The integration of Columbus Serum, a large and well-established value-added distributor serving the mid-Atlantic and Midwestern markets, is proceeding on schedule.
- However, this significant acquisition could continue to negatively affect the operating margins of our veterinary unit for several more quarters.
- Sales of Patterson Medical, our rehabilitation unit, increased 9% in the first quarter to \$109.4 million, reflecting the positive impact of the April 2009 acquisition of Mobilis Healthcare Group in the U.K., and to a lesser extent, the June purchase of the Empi Therapy Supply unit of DJO Incorporated in the U.S.
- While currency adjustments continued to negatively affect Patterson Medical's reported revenues during the quarter, the impact was less severe than during the second half of 2009.
- During the quarter, sales of rehabilitation equipment to acute care hospitals and clinics remained sluggish as the economy and uncertainty surrounding the healthcare reform debate tended to stall customer purchasing decisions.
- The assimilation of the Mobilis acquisition, which has substantially increased Patterson Medical's presence in the U.K. rehabilitation market, is proceeding on schedule.
- The Empi Therapy Supply operation is scheduled to be fully integrated by the end of this year's second quarter.
- The operating margin of Patterson Medical is expected to improve during the second half of this year as these acquired operations are more fully absorbed.
- Turning now to the earnings forecast contained in this morning's release, we are reiterating our previously-reported full-year guidance of \$1.70 to \$1.80 per diluted share for 2010.
- Looking farther down the road, we remain optimistic about Patterson's future.
- Our three businesses, each of which holds the number one or number two position in its served market, are aggressively marketing their products.
- The long-term fundamentals of the dental, veterinary and rehabilitation markets remain strong.
- And, we are continuing to generate substantial operating cash flows, which are providing us with ample resources for supporting our various growth initiatives.
- Given these factors, we are confident that Patterson is moving in the right direction.
- Thank you. Now Steve Armstrong will review some highlights from our first quarter results.

R. Steven Armstrong
 Chief Financial Officer
 Thank you, Jim.

Thank you, Jim.

On a consolidated basis, acquisitions accounted for just over 7 percentage points of our revenue growth for the quarter, while currency exchange had a negative effect of approximately 1.5 percentage points. As Jim mentioned, and as we discussed during our last conference call, there were two developments within the Dental segment that are negatively impacting the year-over-year comparability of consumable revenues. The first of these factors was the decision by a major consumer products company to take its professional toothbrush line direct as opposed to distribution via Patterson Dental. This change, effective in January, reduced our consumable revenue growth by almost two percentage points in the first quarter. We expect this effect to diminish as we replace this lost volume with alternative products. The second item affecting year-over-year comparability resulted from the adoption of the new Patterson Dental Advantages loyalty program in January. Since this program allows customers to accumulate points that they can use against future purchases, we defer a portion of current revenues to account for the credits earned. Consumable revenues were reduced by about 1% for the current quarter due to this change. However, we are very pleased with the impact of the Advantages program on our Dental business. Our consolidated gross margin declined by 100 basis points from the prior year as a result of product mix. This situation is a result of the growth of the Veterinary segment, which carries inherently lower gross margins than our other businesses due to its pharmaceutical product lines. As we move through this fiscal year, we expect this effect will dissipate. The gross margins of the Dental and Medical segments were essentially flat for the quarter. We saw some operating expense leverage in the quarter due to expense control measures we have taken, but this effect was muted due to expenses related to the integration of the Columbus Serum, Mobilis, Dolphin and Empi Therapy operations into our system. This was particularly evident in the Medical segment, where the increase in operating expenses, stemming largely from the Mobilis acquisition, temporarily caused a 180 bps decline in the operating margin. By segment, our first quarter operating margins were 11.0% for Dental, 12.1% for Medical and 4.4% for Veterinary. Our balance sheet shows that our inventory increased by approximately \$30 million at the end of this year's first quarter compared to the year-end balance at April 25th. This rise resulted from normal seasonal increases in our warehouse inventories to improve service levels, along with some impact from the acquisitions we made during the quarter. Our DSO stands at 44 days, compared to 43 in the prior year, while inventory turns are 7.0 compared 6.7 a year ago. The DSO of 44 days at end of the current quarter excludes approximately \$95 million of finance contracts that were generated during a CEREC promotion during the second half of fiscal 2009. These contracts will be sold to our regular funding sources during the second half of this year. We generated cash flow from operations of approximately \$47 million in the first quarter, compared to \$33 million in the year-earlier period. Capital expenditures in the quarter reflect the expansion costs of the Jacksonville distribution center, which will be completed in the second quarter. At that time, Jacksonville will be handling product for each of our three operating divisions. We still estimate capital expenditures to total approximately \$25 million for the full fiscal year. With that, I'll turn it back to the conference operator, who will poll you for your questions.