

2nd Quarter Fiscal 2010 Earnings Conference Remarks

James W. Wiltz
President & Chief Executive Officer

- Good morning and thanks for participating in our second 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.
- As was announced earlier in the quarter, I will be retiring at the end of the current fiscal year.
- Also announced earlier, Scott Anderson, president of Patterson Dental Supply, will be my successor as president and CEO.
- Scott has compiled an outstanding record of achievement during his Patterson career, and I will be working closely with him to ensure a smooth management transition.
- In today's release we announced that Paul Guggenheim, currently southwest region manager of Patterson Dental, will become president of Patterson Dental at the end of fiscal 2010.
- Paul joined Patterson in 2000 following our acquisition of Guggenheim Dental.
- His knowledge of the dental industry, gained over 25 years of experience, and deep understanding of our Company culture will serve him well as he assumes his new responsibilities.
- I, together with our entire Board of Directors, have every confidence that Scott, together with Paul and the other members of his management team, will lead Patterson to continued long-term success.
- 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 fiscal 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 second quarter results, we believe Patterson performed reasonably well amid a very challenging economic environment.
- Consolidated sales of \$815 million were up 7% from \$759 million in the second quarter of 2009.
- As we expected, dental, veterinary and medical acquisitions transacted over the past 12 months accounted for a substantial portion of our second quarter sales growth.
- We also saw internal sales growth, on a comparable basis, in each of our segments for the quarter.
- And, unlike in recent quarters, foreign currency adjustments had only a nominal impact on our second quarter results.
- Second quarter earnings of \$49.3 million, or \$.41 per diluted share, were up 5% from \$46.9 million, or \$0.40 per diluted share, in the second 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 second quarter earnings.
- Turning now to a brief review of our business unit performances, sales of Patterson Dental, our largest business, totaled \$537 million in the second quarter, flat with the year-earlier level.

- Within Patterson Dental, sales of consumable dental supplies and printed office products were down 2% from last year's second quarter, largely reflecting the impact on dental practices of reduced discretionary spending and the high levels of unemployment brought on by the recession.
- However, as we have mentioned previously, two other factors have affected the year-over-year comparability of our consumable revenues.
- First, a major consumer products company elected in January to take its professional toothbrush line direct as opposed to through distribution.
- The impact of this development will diminish as we continue to replace this lost volume with alternative products.
- The comparative impact on our revenue performance of this change, which has averaged about 1 percentage point a quarter, will anniversary during our third quarter.
- A second issue affecting the comparability of our consumable revenues was the result of a change in accounting necessitated by the launch of our new Patterson Dental Advantages loyalty program this past January.
- We now defer a portion of the consumable revenues generated by Advantages customers that will be recognized in the future as the points are redeemed.
- Excluding both of these factors, second quarter consumable revenues would have been virtually unchanged from the year-earlier period.
- All in all, we feel that our consumable business has held up relatively well during the first half of 2010.
- Sales of dental equipment and software rose 3% in the second quarter.
- Within this product category, sales of CEREC® dental restorative systems rose 45%, which offset a 7% decline in sales of basic equipment, including chairs, units and lights.
- We believe the weak economy has been causing many dental practitioners to focus their investment dollars on equipment with rapid and high rates of return.
- This consideration helps explain the strong growth of CEREC dental restorative products thus far in fiscal 2010 and why sales of basic equipment have tended to lag.
- The unequalled performance of CEREC has made it the industry leader by a considerable margin in the category of CAD/CAM dental equipment.
- We believe CEREC is the only viable choice for dentists that want to purchase this type of equipment.
- Sales of Webster Veterinary increased 30% in the second quarter of fiscal 2010 to \$161 million, which was consistent with our internal forecasts.
- Excluding the impact of the Columbus Serum acquisition in October 2008, veterinary sales were up a solid 8%, reflecting higher volumes of veterinary care for companion-pets.
- However, equipment sales remained soft as many veterinary practices remained cautious about purchasing equipment.
- The integration of Columbus Serum, a large and well-established value-added distributor serving the mid-Atlantic and Midwestern markets, is proceeding on schedule.
- As part of the integration process, we are continuing to remove costs from the combined operations, and this process will be largely completed in the third quarter.
- Until then, this significant acquisition will continue to negatively affect the operating margins of our veterinary unit.
- The performance of Patterson Medical, our rehabilitation supply and equipment unit, exceeded our expectations in the second quarter.
- Sales increased 18% to \$117 million, with internal sales accounting for 5% of this increase.
- Acquisitions accounted for the balance of Patterson Medical's second quarter sales growth.
- These included Mobilis Healthcare Group in April 2009, and Empi Therapy Solutions, a unit of DJO Incorporated, in June 2009.

- Patterson Medical definitely increased its share of the global rehabilitation market in the second quarter.
- We also believe that the overall rehabilitation market started firming during this period.
- The integration of the Mobilis and Empi acquisitions are proceeding on schedule, and equally important, more business from these acquired units has been retained than we initially planned.
- We would expect to see a larger contribution to our operating profit from these acquisitions as we move deeper into the year.
- All in all, we believe Patterson Medical's prospects are encouraging.
- Turning now to the earnings forecast contained in this morning's release, we are reiterating our previously-reported guidance of \$1.70 to \$1.80 per diluted share for full-year 2010.
- At the same time, it should be noted that our equipment sales in last year's third quarter were quite strong relative to the rest of the market.
- Just prior to the onset of the financial and economic meltdown last fall, our equipment sales benefited from a stronger pipeline of both CEREC and basic equipment orders.
- As we have reported since then, the basic equipment market has been soft.
- While we have aggressive marketing efforts underway to encourage the dental customer to invest in their practices through both technology products and basic equipment, we remain cautious about our third quarter dental equipment performance.
- 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.
- As a result, we are confident that Patterson is moving in the right direction.
- Thank you. Now Steve Armstrong will review some highlights from our second quarter results.

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

- On a consolidated basis, acquisitions accounted for just over 6 percentage points of our revenue growth for the quarter, while, as Jim stated, currency exchange had a nominal effect.
- Our consolidated gross margin declined by 70 basis points from the prior year as a result of product mix.
- This is primarily due to the relative 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 for two reasons.
- First, we have passed the anniversary of the Columbus Serum acquisition late in the second quarter, thus the relative growth of the Veterinary segment is expected to slow in the latter half of the year.
- Second, and conversely, the Medical acquisitions we previously mentioned will produce higher relative sales for this segment in the second half of our year, and the Medical segment produces the highest gross margins of our three businesses.
- The gross margin for the Dental segment improved 50 basis points in the quarter as the positive impact of the Dolphin software and services business is felt.

- While the Medical segment did experience some erosion in gross margin in the quarter, we would expect improvement as the acquisitions become more fully integrated into the business.
- Our operating expense leverage improved 20 bps in the quarter due to the 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.
- Again, we are expecting improvement in our expense leverage in the second half of the year.
- By segment, our second quarter operating margins were 11.6% for Dental, 14.1% for Medical and 3.6% for Veterinary.
- We are now estimating an effective tax rate for the year of 37.8% as we have seen our effective state rate increase, and we are realizing less benefit from our tax-free investment income.
- Because of this rate change, we had some catch-up expense in the quarter as well as a litany of discrete tax expense items in the second quarter, which, together, account for the 140 bps increase in the tax rate for the quarter.
- Our balance sheet shows that our inventory levels are relatively consistent with this year's first quarter levels.
- The increase of \$25 million from the prior year-end balance results from normal seasonal increases in our warehouse inventories to improve service levels, along with some impact from the acquisitions we made.
- Our DSO stands at 44 days, compared to 44 in the prior year, while inventory turns are 7.2 compared 6.6 a year ago.
- The DSO of 44 days at end of the current quarter excludes approximately \$100 million of finance contracts that were generated during our CEREC promotion during the second half of fiscal 2009.
- These contracts will be sold to our regular funding sources beginning in the third quarter.
- We generated cash flow from operations of approximately \$8 million in the second quarter, compared to \$25 million in the year-earlier period.
- For the first six-months, our cash flow is \$55 million compared to \$58 million for the same period last year.
- The timing of payments on accounts payable and for income taxes in the quarter diminished the operating cash flow.
- We also had some build in receivables from increased sales levels.
- We expect that by year-end much of this working capital effect will have evened out.
- During the quarter, we also repaid \$14 million that we had outstanding at the end of the first quarter under our revolving credit facility.
- We now estimate that capital expenditures for the year will total approximately \$30 to 35 million for the full fiscal year.
- We are negotiating the purchase of an existing facility that will accommodate the consolidation of several of our smaller Midwestern distribution centers as we continue our program to consolidate our logistics functions.
- A build-to-suit project was originally planned for fiscal 2011, but when this existing facility was identified, we decided to move the project forward into fiscal 2010.
- With that, I'll turn it back to the conference operator, who will poll you for your questions.