

MENTOR CORP /MN/
Form 10-Q
February 08, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2004

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 No. 0-7955

MENTOR CORPORATION
(Exact Name of Registrant as Specified in its Charter)

Minnesota
(State or other jurisdiction of
incorporation or organization)

41-0950791
(IRS Employer Identification No.)

201 Mentor Drive, Santa Barbara, California 93111
(Address of Principal Executive Offices) (Zip Code)
Registrant's telephone number including area code: 805/879-6000

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 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 (☒) No (☐)

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

As of February 4, 2005 there were approximately 40,522,308 Common Shares, par value \$.10, outstanding.

MENTOR CORPORATION

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PART I - FINANCIAL INFORMATION**Item 1. Consolidated Financial Statements**

Mentor Corporation
Consolidated Balance Sheets
(Unaudited)

(in thousands)	December 31, 2004	March 31, 2004
<u>Assets</u>		
Current assets:		
Cash and cash equivalents	\$ 60,666	\$ 118,225
Marketable securities	2,054	193
Accounts receivable, net	102,795	106,016
Inventories	78,184	67,912
Deferred income taxes	22,894	22,488
Prepaid expenses and other	20,172	13,205
Total current assets	286,765	328,039
Property and equipment, net	76,414	77,529
Intangible assets, net	36,782	51,014
Goodwill, net	24,661	23,711
Long-term marketable securities and investments	32,021	8,326
Other assets	8,527	10,160
	\$ 465,170	\$ 498,779
See notes to condensed consolidated financial statements.		

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Mentor Corporation
Consolidated Balance Sheets
(Unaudited)

(in thousands)	December 31, 2004	March 31, 2004
<u>Liabilities and shareholders' equity</u>		
Current liabilities:		
Accounts payable	\$ 33,639	\$ 37,126
Warranty and related reserves	24,886	23,396
Accrued compensation	18,938	18,212
Short-term bank borrowings	8,845	10,012
Sales returns	10,035	11,797
Deferred revenue	12,706	6,915
Income taxes payable	-	285
Current portion of purchase price related to acquired technologies and acquisitions	1,200	1,864
Interest payable	-	1,187
Dividends payable	6,890	6,309
Accrued royalties	720	567
Other	14,209	12,260
Total current liabilities	132,068	129,930
Deferred income taxes	2,752	2,549
Long-term accrued liabilities	9,351	17,996
Convertible subordinated notes	150,000	150,000
Shareholders' equity:		
Common Stock, \$.10 par value:		
Authorized - 150,000,000 shares; Issued and outstanding		
40,502,707 shares at December 31, 2004;		
42,059,136 shares at March 31, 2004;	4,050	4,206
Capital in excess of par value	-	-
Accumulated other comprehensive income	30,887	19,122
Retained earnings	136,062	174,976
	170,999	198,304
	\$ 465,170	\$ 498,779
See notes to condensed consolidated financial statements.		

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Mentor Corporation
Consolidated Statements of Income
Three Months Ended December 31, 2004 and 2003
(Unaudited)

(in thousands, except per share data)		Three Months Ended December 31,	
	2004	2003	
Net sales	\$ 120,601	\$ 106,502	
Cost of sales	42,856	40,461	
Gross profit	77,745	66,041	
Selling, general and administrative expense	45,353	40,627	
Research and development expense	8,053	7,216	
	53,406	47,843	
Operating income	24,339	18,198	
Interest expense	(1,346)	(371)	
Interest income	683	394	
Other income, net	432	182	
Income before income taxes	24,108	18,403	
Income taxes	7,779	5,863	
Net income	\$ 16,329	\$ 12,540	
Basic earnings per share	\$ 0.39	\$ 0.27	
Diluted earnings per share ¹	\$ 0.34	\$ 0.26 ¹	
Dividends per share	\$ 0.17	\$ 0.15	
Weighted average shares outstanding			
Basic	42,367	45,769	
Diluted ¹	49,987	48,807 ¹	
See notes to condensed consolidated financial statements.			

¹ Diluted earnings per share and weighted average shares outstanding for the three-months ended December 31, 2003 have been restated to reflect the additional shares that would be issued upon conversion of our 2¾% convertible notes, in accordance with recently adopted Emerging Issue Task Force (EITF) Issue No. 04-8.

Mentor Corporation
Consolidated Statements of Income
Nine Months Ended December 31, 2004 and 2003
(Unaudited)

(in thousands, except per share data)	2004	Nine Months Ended December 31,	2003
Net sales	\$	351,812	\$ 304,871
Cost of sales		127,469	115,395
Gross profit		224,343	189,476
Selling, general and administrative expense		129,173	110,205
Research and development expense		24,636	22,470
		153,809	132,675
Operating income		70,534	56,801
Interest expense		(3,982)	(681)
Interest income		1,631	1,113
Other income (expense), net		249	1,107
Income before income taxes		68,432	58,340
Income taxes		21,915	18,529
Net income	\$	46,517	\$ 39,811
Basic earnings per share	\$	1.10	\$ 0.86
Diluted earnings per share ¹	\$	0.98¹	\$ 0.82 ¹
Dividends per share	\$	0.49	\$ 0.32
Weighted average shares outstanding			
Basic		42,360	46,239
Diluted ¹		50,169¹	48,588 ¹
See notes to condensed consolidated financial statements.			

¹ Diluted earnings per share and weighted average shares outstanding for the nine-months ended December 31, 2004 and 2003 have been restated to reflect the additional shares that would be issued upon conversion of our 2% convertible notes, in accordance with recently adopted Emerging Issue Task Force (EITF) Issue No. 04-8.

Mentor Corporation
Consolidated Statements of Cash Flows
Nine Months Ended December 31, 2004 and 2003
(Unaudited)

(in thousands)

	2004	2003
<u>Operating Activities:</u>		
Net income	\$ 46,517	\$ 39,811
Adjustments to derive cash flows from operating activities:		
Depreciation	11,222	9,770
Amortization	3,977	2,522
Deferred income taxes	908	(1,452)
Tax benefit from exercise of stock options	5,694	2,895
(Gain) loss on sale of assets	1,513	20
Imputed interest on long-term liabilities	15	194
(Gain) loss on long-term marketable securities	14	136
Changes in operating assets and liabilities:		
Accounts receivable	8,217	3,441
Inventories	(5,383)	(6,845)
Prepaid income taxes and other current assets	(6,316)	(3,725)
Accounts payable and accrued liabilities	710	263
Income taxes payable	(633)	171
Net cash provided by operating activities	66,455	47,201
<u>Investing Activities:</u>		
Purchases of property and equipment	(6,818)	(14,200)
Purchases of intangibles	(1,507)	(3,890)
Purchases of marketable securities	(144,192)	(28,331)
Sales of marketable securities	118,587	21,634
Acquisitions, net of cash acquired	-	(13,391)
Net cash used for investing activities	(33,930)	(38,178)
<u>Financing Activities:</u>		
Issuance of convertible notes, net of issuance costs	-	115,540
Sale of warrants	-	11,891
Repurchase of common stock	(79,773)	(68,895)
Proceeds from exercise of stock options	8,990	6,896
Dividends paid	(20,623)	(8,855)
Borrowings (repayments) under line of credit agreements, net	(518)	804
Net cash (used) provided by financing activities	(91,924)	57,381
Effect of currency exchange rates on cash and cash equivalents	1,840	1,066
Increase (decrease) in cash and cash equivalents	(57,559)	67,470
Cash and cash equivalents at beginning of year	118,225	105,840
Cash and cash equivalents at end of period	\$ 60,666	\$ 173,310

See notes to condensed consolidated financial statements.

MENTOR CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004

Note A - Business Activity

Mentor Corporation (the "Company") was incorporated in April 1969. Unless the context indicates otherwise, when we refer to "Mentor," "we," "us," "our," or the "Company" in this Form 10-Q, we are referring to Mentor Corporation and its subsidiaries on a consolidated basis. We develop, manufacture and market a broad range of products serving the medical specialties market. Our products are utilized by three primary segments, aesthetic and general surgery (plastic and reconstructive surgery), surgical urology, and clinical and consumer healthcare. Aesthetic and general surgery products include surgically implantable prostheses for plastic and reconstructive surgery as well as capital equipment and consumables used for soft tissue aspiration or body contouring (liposuction). Surgical urology products include surgically implantable prostheses for the treatment of impotence, surgically implantable incontinence products, urinary care products and brachytherapy seeds for the treatment of prostate cancer. Clinical and consumer healthcare products include catheters and other products for the management of urinary incontinence and retention.

Note B - Summary of Significant Accounting Policies

The consolidated financial statements include the accounts of the Company and all of its subsidiaries in which a controlling interest is maintained. For those subsidiaries where the Company owns less than 100%, the outside shareholders' interests are treated as minority interests. All inter-company accounts and transactions have been eliminated. Certain prior year amounts in previously issued financial statements have been reclassified or restated to conform to the current year presentation.

Basis of Presentation

The financial information for the three and nine-months ended December 31, 2004 and 2003 is unaudited but includes all adjustments (consisting only of normally recurring accruals, unless otherwise indicated) that the Company considers necessary for a fair presentation of the results of operations for these periods. Interim results are not necessarily indicative of results for the full fiscal year.

Use of Estimates

Financial statements prepared in accordance with accounting principles generally accepted in the United States require management to make estimates and judgments that affect amounts and disclosures reported in the financial statements. Actual results could differ from those estimates. A discussion of the Company's significant accounting policies is described in the "Application of Critical Accounting Policies" section of "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Effects of Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued a revision to FAS No. 123, Share-Based Payment. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, and supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees. Statement 123(R) covers a wide range of share-based compensation arrangements and requires that the compensation cost related to these types of payment transactions be recognized in financial statements. Cost will be measured based on the fair value of the equity or liability instruments issued. Statement 123(R) becomes effective for period starting after June 15, 2005. The Company has not completed its analysis of the impact of the adoption of 123(R), however, the effect of the adoption on earnings per share is estimated to be the same as that shown in Note K – Stock Options.

In November 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 151, Inventory Costs, which amends the guidance in ARB No. 43, Chapter 4, Inventory Pricing. This amendment clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criteria specified in ARB 43 of "so abnormal". In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. This Statement is effective for financial statements for fiscal years beginning after June 15, 2005. The impact upon adoption of SFAS No. 151 is not expected to have a material impact on the results of operations or the financial position of the Company.

In September 2004, the Financial Accounting Standards Board (FASB) confirmed Emerging Issue Task Force (EITF) Issue No. 04-8, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share," with an effective date of December 15, 2004. The EITF reflects the Task Force's conclusion that contingently convertible debt should be included in diluted earnings per share calculations regardless of whether or not the trigger price has been reached. The Company adopted EITF 04-8 in the quarter ending December 31, 2004 and retroactively restated the weighted average shares outstanding for diluted earnings per share for the three-months and nine-months ended December 31, 2003 and for the nine-months ended December 31, 2004. The impact of the EITF changed the diluted earnings per share calculation by increasing net income used in the numerator by the after tax amount of interest expense related to the convertible notes (approximately \$800,000 per quarter), and increasing weighted average shares outstanding used in the denominator by approximately 5.1 million shares; the number of shares to be issued upon full conversion of the convertible notes. The effect of the restatement was a decrease in diluted earnings per share of approximately \$.02 cents per share for the quarter ended December 31, 2004 and \$0.06 cents per share for the nine-months ended December 31, 2004.

In March 2004, the Financial Accounting Standards Board (FASB) approved the consensus reached on the EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." The objective of this Issue is to provide guidance for identifying impaired investments. EITF 03-1 also provides new disclosure requirements for investments that are deemed to be temporarily impaired. The accounting provisions of EITF 03-1 are effective for all reporting periods beginning after June 15, 2004, while the disclosure requirements are effective only for annual periods ending after June 15, 2004. We have evaluated the impact of the adoption of EITF 03-1 and do not believe it will be significant to our results of operations or financial position.

Note C - Interim Reporting

The Company's three quarterly interim reporting periods are each thirteen-week periods ending on the Friday nearest the end of the third calendar month of each calendar quarter. The fiscal year end remains March 31st. To facilitate ease of presentation, each interim period is shown as if it ended on the last day of the appropriate calendar month. The actual dates for each of the three interim quarters-end are shown below:

	<u>Fiscal 2005</u>	<u>Fiscal 2004</u>
First Quarter	July 2, 2004	June 27, 2003
Second Quarter	October 1, 2004	September 26, 2003
Third Quarter	December 31, 2004	January 2, 2004

The accompanying unaudited condensed consolidated financial statements for the three-month and nine-month periods ended December 31, 2004 and 2003 have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting only of normally recurring accruals, unless otherwise indicated) considered necessary for a fair presentation of the results of operations for the indicated periods have been included. Certain amounts recorded in previous periods have been reclassified or restated to conform to the current period presentation. Operating results for the three-month and nine-month periods ended December 31, 2004 are not necessarily indicative of the results for the full fiscal year.

The balance sheet at March 31, 2004 has been derived from the audited financial statements as of that date, but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

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The condensed consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended March 31, 2004.

Note D - Cash Equivalents, Marketable Securities, and Long-Term Marketable Securities and Investments

All highly liquid investments with maturities of three months or less at the date of purchase are considered to be cash equivalents.

The Company considers its marketable securities available-for-sale as defined in Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Realized gains and losses, and declines in value considered to be other than temporary, are included in income. The cost of securities sold is based on the specific identification method. For short-term marketable securities, there were no material realized or unrealized gains or losses, nor were there any material differences between estimated fair values, based on quoted market prices, and the costs of securities in the investment portfolio as of December 31, 2004, and March 31, 2004. Short-term investments, except auction rate securities, mature between three months and one year from the purchase date. The Company's short-term marketable securities consist primarily of money market mutual funds, U.S. state and municipal government and government agency obligations, auction rate securities, and investment grade corporate obligations, including commercial paper. Auction rate securities carry interest or dividend rates that reset every 28 days, but have contractual maturities of greater than one year.

The Company's long-term marketable securities and investments include investments in Federal Home Loan Bank and Mortgage Association bonds (FHLM bonds) with maturities of two to four years.

Available-for-sale investments at December 31, 2004 were as follows:

(in thousands)		Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash balances	\$	23,478	\$ -	\$ -	23,478
Money market mutual funds		37,188			37,188
Marketable equity securities		144		(14)	130
U.S., state and municipal agency obligations		33,935		(268)	33,667
Corporate debt securities		278			278
Total available-for-sale investments	\$	95,023	\$ -	(282)	94,741
Included in cash and cash equivalents		60,666			60,666
Included in current marketable securities		2,054			2,054
Included in long-term marketable securities and investments		32,303		(282)	32,021
Total available-for-sale investments	\$	95,023	\$ -	(282)	94,741

Available-for-sale investments at March 31, 2004 were as follows:

(in thousands)		Adjusted Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Cash balances	\$	19,139	\$ -	\$ -	19,139
Bank time deposits		-	-	-	-
Money market mutual funds		99,086	-	-	99,086
Marketable equity securities		56	-	(8)	48
U.S., state and municipal agency obligations		8,193	-	-	8,193
Corporate debt securities		278	-	-	278
Total available-for-sale investments	\$	126,752	\$ -	(8)	126,744
Included in cash and cash equivalents		118,225	-	-	118,225
Included in current marketable securities		193	-	-	193
		8,334	-	(8)	8,326

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Included in long-term marketable
securities and investments

Total available-for-sale investments	\$	126,752	\$	-	\$	(8)	\$	126,744
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Note E – Inventories

Inventories are stated at the lower of cost or market, cost determined by the first-in, first-out (FIFO) method. The Company writes down its inventory for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions.

Inventories at December 31, 2004 and March 31, 2004 consisted of:

(in thousands)		December 31,	March 31,
Raw materials	\$	16,580	\$ 13,050
Work in process		11,039	11,572
Finished goods		50,565	43,290
	\$	78,184	\$ 67,912

Note F - Property and Equipment

Property and equipment is stated at cost. Depreciation is based on the useful lives of the properties and computed using the straight-line method. Buildings are depreciated over 30 years, furniture and equipment over 3 to 10 years and leasehold improvements over the shorter of their estimated remaining lives or lease terms. Significant improvements and betterments are capitalized while maintenance and repairs are charged to operations as incurred.

Property and equipment at December 31, 2004 and March 31, 2004 consisted of:

(in thousands)		December 31,	March 31,
Land	\$	586	\$ 561
Buildings		26,227	24,534
Leasehold improvements		25,565	23,776
Furniture, fixtures and equipment		110,830	103,242
Construction in progress		3,419	3,811
		166,627	155,924
Less accumulated depreciation		(90,213)	(78,395)
	\$	76,414	\$ 77,529

Note G - Warranties

The Company provides an accrual for the estimated cost of product warranties and product liability claims at the time revenue is recognized. Such accruals are based on estimates, taking into consideration relevant factors such as historical experience, the warranty period, estimated costs, existence and levels of insurance and insurance retentions, identified product quality issues, if any, and to a limited extent, information developed by the insurance company using actuarial techniques. The Company assesses the adequacy of these accruals periodically and adjusts the amounts as necessary based on actual experience and changes in future expectations.

Information on changes in the Company's accrued warranties and related reserves are as follows:

(in thousands)		Nine Months Ended December 31,	
		2004	2003
Beginning warranty and related reserve	\$	23,396	\$ 19,989
Costs of warranty claims		(3,081)	(2,876)
Accruals for product warranties		4,571	5,422
Ending warranty and related reserves	\$	24,886	\$ 22,535

Note H - Other Comprehensive Income

The components of comprehensive income are listed below:

(in thousands)	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
Net income	\$ 16,329	\$ 12,540	\$ 46,517	\$ 39,811
Foreign currency translation adjustment	10,356	8,381	11,927	14,239
Unrealized (losses) on marketable securities and investment activities, net	(118)	(44)	(162)	102
Comprehensive income	\$ 26,567	\$ 20,877	\$ 58,282	\$ 54,152

Note I - Income Taxes

The effective rate of corporate income taxes was 32.0% and 31.8% for the nine-month period ended December 31, 2004 and 2003, respectively.

Note J - Earnings per Share

Basic earnings per share is computed by dividing net income available to common shareholders by the weighted average number of shares of the Company's common shares outstanding during the period. Diluted earnings per share is calculated in the same manner as basic earnings per share except that when the effect is dilutive, net income is increased by the after tax interest expense on the convertible notes, and the number of shares outstanding is increased by potentially dilutive common shares outstanding during the period. Potentially dilutive common shares consist of shares issuable under the terms of employee stock options, warrants, and the 2¾% convertible subordinated notes. A reconciliation of net income for basic earnings per share to net income for diluted earnings per share and weighted average shares outstanding, used to calculate basic earnings per share, to weighted average shares outstanding assuming dilution, used to calculate diluted earnings per share, follows:

(in thousands except per share data)	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
Net income: as reported ¹	\$ 16,329	\$ 12,540	\$ 46,517	\$ 39,811
Add back after tax interest expense on convertible note	802	145	2,406	145
Net income for numerator of diluted earnings per share	\$ 17,131	\$ 12,685	\$ 48,923	\$ 39,956

¹ Net income as reported includes no compensation expense associated with stock options.

(in thousands)	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
Weighted average outstanding shares: basic	42,367	45,769	42,360	46,239
Shares issuable through exercise of stock options	2,492	2,147	2,685	2,052
Shares issuable through convertible notes	5,128	891	5,124	297
Weighted average outstanding shares: diluted	49,987	48,807	50,169	48,588
Basic earnings per share	\$ 0.39	\$ 0.27	\$ 1.10	\$ 0.86
Diluted earnings per share ²	\$ 0.34	\$ 0.26 ²	\$ 0.98	\$ 0.82 ²

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² Diluted earnings per share and weighted average shares outstanding for the nine-months ended December 31, 2004 and 2003 have been restated to reflect the additional shares that would be issued upon conversion of our 2¾% convertible notes, in accordance with recently adopted Emerging Issue Task Force (EITF) Issue No. 04-8.

Shares issuable through stock options are determined using the treasury stock method. Certain potential shares issuable under the terms of employee stock options were excluded from the computation of diluted earnings per share since their exercise prices were greater than the market prices of the common shares during or at the end of the period, and accordingly, their effect would have been anti-dilutive. Shares potentially issuable upon the conversion of our 2¾% convertible subordinated notes are included in the calculation when the effect of the conversion would be dilutive on diluted earnings per share even though the notes were not convertible because the market prices of the common shares did not reach the required levels for the required periods of time. Additionally, during the quarter ended December 31, 2004, the price of the Company's common shares did not exceed the specific strike prices of the convertible note hedge or the warrant agreements which may reduce the potential dilution from any conversion of the notes. Both the bond hedge and the warrants transaction may be settled at the Company's option, either in cash or shares, and expire on January 1, 2009.

Note K - Stock Options

The Company has granted options to key employees and non-employee directors under its Amended 2000 Long-Term Incentive Plan (2000 Plan) and 1991 Plan. Options granted under both plans are exercisable in four equal annual installments beginning one year from the date of grant, and expire ten years from the date of grant. Options are granted at the fair market value as of the date of grant.

Stock option exercise prices are set at the fair market value of the Company's common stock on the date of grant and the related number of shares granted is fixed at that point in time. Therefore, under the principles of Accounting Principles Board (APB) Opinion 25, the Company does not recognize compensation expense associated with the grant of stock options. SFAS 123 "Accounting for Stock-Based Compensation", requires the use of an option valuation model to provide supplemental information regarding options granted after fiscal 1995. Pro forma information regarding net income and earnings per share shown below were determined as if the Company had accounted for its employee stock options under the fair value method of that statement. The estimated fair value of the options is amortized ratably over the options' vesting period. As required by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure - an amendment of FASB Statement No. 123", the following table shows the estimated effect on net income and earnings per share if the Company had applied the fair value recognition provision of SFAS 123 to stock-based employee compensation. The Company's pro forma information is as follows:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
(in thousands except per share data)				
Net income: as reported ¹	\$ 16,329	\$ 12,540	\$ 46,517	\$ 39,811
Deduct: compensation expense fair value method	(1,642)	(2,179)	(5,197)	(5,795)
Net income: pro forma	\$ 14,687	\$ 10,361	\$ 41,320	\$ 34,016
Basic earnings per share: as reported	\$.39	\$.27	\$ 1.10	\$.86
Basic earnings per share: pro forma	\$.35	\$.23	\$.98	\$.74
Net income: as reported ¹	\$ 16,329	\$ 12,540	\$ 46,517	\$ 39,811
Add back after tax interest expense on convertible notes	802	145	2,406	145
Net income: diluted earnings per share	17,131	12,685	48,923	39,956
Deduct: compensation expense fair value method	(1,642)	(2,179)	(5,197)	(5,795)
Net income: diluted earnings per share pro forma	\$ 15,489	\$ 10,506	\$ 43,726	\$ 34,161
Diluted earnings per share: as reported ²	\$.34	\$.26 ²	\$.98	\$.82 ²
Diluted earnings per share: pro forma ²	\$.29	\$.21 ²	\$.82	\$.69 ²

¹ Net income as reported includes no compensation expense associated with stock options.

² Diluted earnings per share and weighted average shares outstanding for the nine-months ended December 31, 2004 and 2003 have been restated to reflect the additional shares that would be issued upon conversion of our 2¾% convertible notes, in accordance with recently adopted Emerging Issue Task Force (EITF) Issue No. 04-8.

Note L - Share Repurchase Program

The Company has a stock repurchase program to provide liquidity to the market and to reduce the overall number of shares outstanding, which has helped offset the dilutive effects of our employee stock option program (Long-Term Incentive Plan) and EITF Issue No. 04-8 related to the inclusion of contingently convertible debt in fully diluted earnings per share calculations. All shares repurchased under the program are retired and are no longer deemed to be outstanding. At March 31, 2003, 1.8 million shares remained authorized for repurchase under prior years Board of Directors authorization. On July 31, 2003 the Board of Directors increased the authorized number of shares to be repurchased from 1.8 million to 4.0 million shares. On December 5, 2003, the Board of Directors increased the authorized number of shares to be repurchased by 5.0 million shares from 2.5 million to 7.5 million shares. During fiscal 2004, 5.4 million shares were repurchased for \$135.8 million and 3.6 million shares remained authorized for repurchase as of March 31, 2004. During fiscal 2005, 2.3 million shares were repurchased for \$79.8 million and 1.3 million shares remained authorized for repurchase as of December 31, 2004. See Note P – Related Party Transactions for additional information on the share repurchase. The timing of repurchases is subject to market conditions, cash availability, and blackout periods during which the Company is restricted from repurchasing shares. There is no guarantee that shares authorized for repurchase by the Board will ultimately be repurchased.

Note M - Acquisitions

South Bay Medical LLC

On January 19, 2001, the Company purchased the assets of South Bay Medical LLC (South Bay), a company focused on the development of a new computer-based workstation and automated cartridge-based needle loading system for use in brachytherapy procedures. The acquisition was accounted for as a purchase with the results of operations included in the Company's financial statements from the date of acquisition. The Company paid \$2 million in cash and issued restricted common stock valued at \$4 million on the date of purchase. Additional purchase price payments will be made to South Bay over the next few years as workstation sales are made. The net present value of these amounts is recorded at December 31, 2004, in current accrued liabilities (\$0.2 million) and in long-term accrued liabilities (\$0.7 million) as the Company believes it is probable these payments will be made.

Prosurg, Inc.

In December 2001, the Company entered into several agreements with Prosurg, Inc., to acquire certain patent rights and obtain a source of supply of a bio-absorbable co-polymer for \$2 million in cash and up to an additional \$2 million upon the achievement of certain milestones. The purchase price was allocated to intangible assets and the net present value of these amounts is recorded at December 31, 2004, in accrued liabilities (\$1.0M) and in long-term accrued liabilities (\$1.0M) as the Company believes it is probable these payments will be made.

A-Life Ltd.

On August 25, 2003, the Company completed the acquisition of A-Life Ltd, which has developed a hyaluronic acid based dermal filler product, from Vitrolife, AB. The acquisition was valued at \$7.5 million; net of cash acquired, and was paid from existing cash balances. The purchase price was allocated to the tangible and intangible net assets acquired on the basis of their respective fair values on the acquisition date. The purchase price was preliminarily allocated to accounts receivable of \$36,000, other assets of \$349,000, production equipment of \$393,000 and intangible assets of \$6,821,000, net of accrued liabilities of \$123,000.

Note N – Goodwill & Intangible Assets

In 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 142 was effective for the Company as of April 1, 2002. SFAS No. 142 specifies the financial accounting and reporting for acquired goodwill and other intangible assets. Goodwill and intangible assets that have indefinite useful lives are no longer to be amortized, but rather are to be tested for impairment annually or more frequently if impairment indicators arise. None of the Company's intangible assets have an indefinite life. Intangible assets with finite lives continue to be amortized over their useful lives ranging from 3-20 years on a straight line basis. Goodwill and intangible assets have been recorded at either incurred or allocated cost. Allocated costs were based on respective fair values at the date of acquisition.

Note K - Stock Options

Upon the adoption of SFAS No. 142, the Company reassessed the remaining amortization periods of intangible assets acquired on or before June 30, 2001, and assigned all goodwill to reporting units for impairment testing. The impairment tests involve the use of both estimates of fair value for the Company's reporting units as well as discounted cash flow assumptions. Impairment tests were performed at adoption and in the fourth quarter of fiscal years 2004 and 2003 and no impairment was noted as a result of these analyses.

In the quarter ended December 31, 2004 the Company determined that certain purchase price payments to South Bay Medical related to future sales of workstations were no longer probable, and accordingly, reduced the liabilities captioned "current portion of purchase price related to acquired technologies and acquisitions" and "long-term accrued liabilities" by a total of approximately \$10.4 million. This determination was considered a potential impairment indicator and the Company also reduced the value of the patents and technologies related to the workstations based on future expected sales levels by \$10.4 million. The combined adjustments had no effect on net income.

As of December 31, 2004 and March 31, 2004, accumulated amortization of intangible assets was \$14.8 million and \$14.2 million, respectively.

Note O - Long-Term Debt

On December 22, 2003, the Company completed an offering of \$150 million of convertible subordinated notes due January 1, 2024 pursuant to Rule 144A under the Securities Act of 1933. The notes bear interest at 2¾% per annum and are convertible into shares of the Company's common stock at a conversion price of \$29.25 per share and are subordinated to all existing and future senior debt.

Holders of the notes may convert their notes only if any one of the following conditions is satisfied:

- during any fiscal quarter prior to January 1, 2019, if the closing price of the Company's common stock for at least 20 trading days in the 30 consecutive trading day period ending on the first trading day of such fiscal quarter is more than 120% of the conversion price per share of the Company's common stock on such trading day;
- any business day on or after January 1, 2019, if the closing price of the Company's common stock on the immediately preceding trading day is more than 120% of the conversion price per share of the Company's common stock on such trading day;
- during the five business day period after any five consecutive trading day period if the average of the trading prices of the notes for such five consecutive trading day period is less than 98% of the average of the conversion values of the notes during such period, subject to certain limitations;
- if the Company calls the notes for redemption; or
- if the Company makes certain significant distributions to holders of its common stock or the Company enters into specified corporate transactions.

At an initial conversion price of \$29.289, each \$1,000 principle amount of notes will be convertible into 34.1425 shares of common stock. As a result of the Company's recent dividend increase the conversion price has been adjusted to \$29.25, and each \$1,000 principle amount will be convertible into 34.1880 shares of common stock.

Concurrent with the issuance of the convertible subordinated notes, the Company entered into a convertible note hedge and a warrants transaction with respect to its common stock, the exposure for which is held by Credit Suisse First Boston LLC. Both the note hedge and the warrants transaction may be settled at the Company's option either in cash or shares and expire January 1, 2009. The convertible note hedge and warrants transactions combined are intended to reduce the potential dilution from conversion of the notes by effectively increasing the conversion price per share to approximately \$39.43. The cost of the note hedge and the proceeds of warrants sale have been included in shareholders' equity in accordance with the guidance in Emerging Issues Task Force No. 00-19, "Accounting for Derivative Financial Instruments Indexed to and Potentially Settled in a Company's own Stock." Any proceeds received or payments made upon termination of these instruments will be recorded in shareholders' equity.

Note P - Related Party Transactions

On December 13, 2004, the Company repurchased 1,500,000 shares of its common stock from two investment partnerships managed by VA Partners, LLC, at the time our largest shareholder, at a purchase price of \$33.85 per share, the closing price of the common stock on the NYSE on that date. On December 14, the Company repurchased an additional 750,000 shares of its common stock from the same investment partnerships at \$34.00 per share, a discount to the \$34.41 closing price on the NYSE on that date. The 2.25 million shares were repurchased for a total of \$76.3 million pursuant to the Company's continuing stock repurchase program and represented approximately 5% of outstanding shares before the occurrence of the transactions. VA Partners, LLC, through several of its investment partnerships, owned 6.9 million shares representing approximately 16% of our outstanding common stock prior to these transactions. Mr. Jeff Ubben, a managing member of VA Partners, LLC, is a member of Mentor's Board of Directors. The Company's Audit Committee evaluated and pre-approved the transaction.

Note Q - Business Segment Information

The Company's operations are principally managed and reported on a product basis. There are three reportable segments: aesthetic and general surgery, surgical urology, and clinical and consumer healthcare. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies except that certain expenses such as interest and certain corporate expenses are not allocated to the segments.

The aesthetic and general surgery products segment consists primarily of breast implants, tissue expanders and the Company's body contouring (liposuction) equipment and disposables. The surgical urology segment includes penile implants, surgical incontinence products, and brachytherapy seeds for the treatment of prostate cancer. The clinical and consumer healthcare segment includes catheters and other disposable products for the management of urinary incontinence and retention.

Selected financial information for the Company's reportable segments for the three-month and nine-month periods ended December 31, 2004 and 2003 and as of December 31, 2004 and March 31, 2004 is as follows:

(in thousands)	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
Net sales				
Aesthetic and General Surgery	\$ 63,181	\$ 54,821	\$ 183,047	\$ 157,523
Surgical Urology	31,881	26,521	94,167	78,513
Clinical and Consumer Healthcare	25,539	25,160	74,598	68,835
Total consolidated revenues	\$ 120,601	\$ 106,502	\$ 351,812	\$ 304,871
Operating profit				
Aesthetic and General Surgery	\$ 23,116	\$ 18,233	\$ 67,052	\$ 53,524
Surgical Urology	2,602	(1,034)	5,950	97
Clinical and Consumer Healthcare	2,419	3,541	8,174	10,118
Total reportable segments	\$ 28,137	\$ 20,740	\$ 81,176	\$ 63,739
Operating income				
Reportable segments	\$ 28,137	\$ 20,740	\$ 81,176	\$ 63,739
Corporate operating expenses	(3,798)	(2,542)	(10,642)	(6,938)
Interest expense	(1,346)	(371)	(3,982)	(681)
Interest income	683	394	1,631	1,113
Other income	432	182	249	1,107
Income before income taxes	\$ 24,108	\$ 18,403	\$ 68,432	\$ 58,340

(in thousands)	As of	
	December 31, 2004	March 31, 2004
Identifiable assets		
Aesthetic and General Surgery	\$ 136,882	\$ 135,199
Surgical Urology	111,157	114,937
Clinical and Consumer Healthcare	76,356	76,695
Total reportable segments	\$ 324,395	\$ 326,831

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Cautionary Statement:

The following discussion and analysis should be read in conjunction with our Unaudited Condensed Consolidated Financial Statements and related Notes thereto contained elsewhere in this Report. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our securities. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission ("SEC"), including our Annual Report on Form 10-K for the year ended March 31, 2004, and subsequent reports on Forms 10 Q and 8 K, which discuss our business in greater detail.

The section entitled "Risk Factors" set forth below, and similar discussions in our other SEC filings, discuss some of the important risk factors that may affect our business, results of operations and financial condition. These risks, in addition to the other information in this Report and in our other filings with the SEC, should be carefully considered before deciding to purchase, hold or sell our securities.

All statements included in this Report, other than statements or characterizations of historical fact, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Examples of forward-looking statements include, but are not limited to, statements concerning:

- our anticipated growth strategies;
- our anticipated sales, expenses and taxes for fiscal 2005;
- our intention to introduce or seek regulatory approval for new products;
- our ability to continue to meet FDA and other regulatory requirements;
- our anticipated outcomes of litigation and regulatory reviews;
- our ability to replace sources of supply without disruption or regulatory delay;
- our accounting estimates, assumptions and judgments, the market acceptance and performance of our products, the competitive nature of and anticipated growth in our markets;
- our ability to consummate acquisitions and integrate their operations successfully; and
- the need for capital.

These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Forward-looking statements can often be identified by words such as "anticipates," "expects," "intends," "plans," "predicts," "projects," "believes," "seeks," "estimates," "may," "will," "should," "would," "could," "potential," "continue," "ongoing," "guidance," and similar expressions, and variations or negatives of these words. In addition, any statements that refer to expectations, projections, forecasts or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. These forward-looking statements speak only as of the date of this Report and are based upon the information available to us at this time. Such information is subject to change, and we will not necessarily inform you of such changes. These statements are not guarantees of future results and are

subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statement as a result of various factors, some of which are listed under the section "Risk Factors" below. We undertake no obligation to revise or update publicly any forward-looking statement for any reason.

Company Overview

Founded in 1969, we are a leading supplier of medical products for the global health care market. We develop, manufacture and market a broad range of products serving the medical specialties market. Our products are utilized by three primary segments, aesthetic and general surgery (plastic and reconstructive surgery), surgical urology, and clinical and consumer healthcare.

Our aesthetic and general surgery products include surgically implantable prostheses for plastic and reconstructive surgery, as well as capital equipment and consumables used for soft tissue aspiration or body contouring (liposuction). Our surgical urology products include surgically implantable prostheses for the treatment of impotence, surgically implantable incontinence products, urinary care products and brachytherapy seeds for the treatment of prostate cancer. Our clinical and consumer healthcare products include catheters and other products for the management of urinary incontinence and retention.

We employ approximately 2,000 people around the world and are headquartered in Santa Barbara, California, with manufacturing and research operations in the United States, France, the Netherlands and the United Kingdom. We also purchase finished products and certain raw material components from third party manufacturers and suppliers. The cost of goods sold represents raw materials, labor and overhead, and the cost of third party finished products. Gross margins may fluctuate from period to period due to changes in the selling prices of our products, the mix of products sold, changes in the cost of third party finished products, raw materials, labor and overhead and manufacturing efficiencies or inefficiencies.

In addition to our strong domestic presence, we export most of our product lines, principally to Canada, Western Europe, Central and South America, and the Pacific Rim. Products are sold through our direct international sales offices in Canada, the United Kingdom, Germany, France, Japan, Benelux, Australia, Spain, Portugal and Italy, as well as through independent distributors in other countries.

We employ specialized domestic sales forces for each of our domestic business franchises. These franchises are aesthetics surgery and urologic specialties, which includes our women's health, erectile dysfunction and clinical and consumer healthcare, and prostate brachytherapy product lines.

Our selling, general and administrative expense incorporates the expenses of our sales and marketing organization and the general and administrative expenses necessary to support the global organization. Our sales and marketing expenses consist primarily of salaries, commissions, and marketing program costs. General and administrative expenses incorporate the costs of finance, human resources, information services, legal and insurance costs.

Our research and development expenses are comprised of the following types of costs incurred in performing clinical development and research and development activities: salaries and benefits, allocated overhead, clinical trial and related clinical manufacturing costs, regulatory costs, contract services, and other outside costs. We also conduct research on materials technology, product design and product improvement.

Recent Developments

On October 25, 2003, we completed the acquisition of Inform Solutions Inc., now doing business as Mentor Solutions, located in San Diego, California. Mentor Practice Development is a leading provider of comprehensive integrated practice management software and revenue enhancement services to the plastic surgery industry. We paid cash for the acquisition and committed to several milestone payments over the ensuing three years based upon sales and earnings. We expect that the software and consulting revenues generated by Mentor Solutions will not be substantial. We do, however, generally anticipate that the software and services Mentor Solutions offers will assist our plastic surgery customers to better manage their practices and increase aesthetic surgeries, resulting in growth of our related product sales.

On December 10, 2003 we completed a licensing agreement with the Wisconsin Alumni Research Foundation ("WARF"), which gives us the exclusive manufacturing and marketing rights to proprietary botulinum toxin technology developed at the University of Wisconsin-Madison. In exchange, we paid cash and committed to royalty payments based upon future sales, and future payments based upon developmental milestones. We do not expect any revenues from products utilizing this technology in fiscal year 2005 or fiscal year 2006, as the products will require additional research, clinical studies and regulatory approvals before they can be marketed.

On December 22, 2003, we completed an offering of \$150 million of convertible subordinated notes due January 1, 2024 pursuant to Rule 144A under the Securities Act of 1933. The notes bear interest at 2¾% per annum and are convertible into shares of our common stock at an adjusted conversion price of \$29.25 per share and are subordinated to all existing and future senior debt.

APPLICATION OF CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis of Financial Condition and Results of Operations addresses our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates and judgments. We base our estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Management has identified the critical accounting policies to be those related to revenue recognition, accounts receivable, inventories, warranties and related reserves, and goodwill and intangible asset impairment. These accounting policies are discussed in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" and notes to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2004.

RESULTS OF OPERATIONS

The following table sets forth certain data from the Consolidated Statements of Income expressed as a percentage of net sales for the periods indicated:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2004	2003	2004	2003
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of sales	35.5%	38.0%	36.2%	37.9%
Gross profit	64.5%	62.0%	63.8%	62.1%
Selling, general and administrative expense	37.6%	38.1%	36.7%	36.1%
Research and development expense	6.7%	6.8%	7.0%	7.4%
Operating income	20.2%	17.1%	20.1%	18.6%
Interest expense	(1.1)%	(0.3)%	(1.1)%	(0.2)%
Interest income	0.6%	0.3%	0.5%	0.4%
Other income (expense), net	0.3%	0.2%	-%	0.4%
Income before income taxes	20.0%	17.3%	19.5%	19.2%
Income taxes	6.5%	5.5%	6.3%	6.1%
Net income	13.5%	11.8%	13.2%	13.1%

For the three-month period ended December 31, 2004 compared to the three-month period ended December 31, 2003**Sales**

Sales for the three-month period ended December 31, 2004 increased 13.2% to \$120.6 million from \$106.5 million for the same quarter in the prior year. Foreign exchange rate movements, primarily the strengthening of the Euro, had a favorable year-to-year impact on sales of \$3.6 million for the three-month period. We expect total sales to be in the range of \$475 million to \$480 million in fiscal 2005, representing low-teen percentage growth over sales in fiscal 2004.

	Sales by Principal Product Line Three Months Ended December 31,			Percent Change
(in thousands)	2004	2003		
Aesthetic & General Surgery Products	\$ 63,181	\$ 54,821		15.2%
Surgical Urology Products	31,881	26,521		20.2%
Clinical & Consumer Healthcare Products	25,539	25,160		1.5%
	\$ 120,601	\$ 106,502		13.2%

Sales of aesthetic and general surgery products increased 15.2% to \$63.2 million for the quarter ended

December 31, 2004, from \$54.8 million in the same period in the prior year. Approximately \$0.9 million of this increase is attributable to the favorable impact of foreign exchange rate movements, and the balance is primarily attributable to organic growth of our silicone gel breast implants and products associated with breast reconstruction surgeries. Total sales of breast implant products increased 13% to \$54.2 million for the quarter from \$48.0 million in the same period in the prior year. Increased sales were driven by growth in the augmentation and reconstruction markets both domestically and internationally. Although we try to avoid competing on price, we continue to see competitive price pressure in both the domestic and international markets. Sales of body contouring products increased 14% to \$4.6 million for the quarter from \$4.1 million in the same period in the prior year. Liposuction continues to be the leading surgical cosmetic procedure in the United States, and sales of our capital equipment, associated disposable products, and higher average selling prices were the leading contributors to body contouring sales growth for the quarter ended December 31, 2004. Other aesthetic products sales increased 60% to \$4.3 million for the quarter from \$2.7 million in the same period of the prior year, primarily as a result of increased revenue from physician participation in our "Extreme Mentor" direct to consumer television advertising program.

Sales of surgical urology products increased 20.2% to \$31.9 million for the quarter ended December 31, 2004, from \$26.5 million in the same period in the prior year. Sales of our disposable urinary care products increased by \$3.0 million to \$16.1 for the quarter ended December 31, 2004 compared to \$13.1 million in the same period in the prior year. The majority of this increase was attributable to increased sales at our international branches. Sales of women's health products increased 37% to \$5.4 million for the three-months ended December 31, 2004, compared to \$3.9 million in the prior year. This increase was primarily attributable to our ObTape[®] sling product, which was introduced in the United States during August 2003 for the treatment of stress urinary incontinence. Penile implant sales increased 10% to \$6.5 million, from \$5.9 million in the comparable period of the prior year, due to continued market acceptance of our Titan[®] penile device in Europe and a reduction in the trend of patients sampling competitive drug therapies for erectile dysfunction, which had negatively impacted prior year sales. Brachytherapy product sales increased by 7% to \$3.9 million for the quarter ended December 31, 2004, from \$3.7 million in the same period in the prior year, primarily as a result of higher unit sales. The favorable impact of foreign exchange rate variations for the surgical urology product segment, which primarily benefits our disposable urinary care products, was \$1.5 million for the quarter ended December 31, 2004, compared to the prior year.

Sales of clinical and consumer healthcare products totaled \$25.5 million for the quarter ended December 31, 2004, and were relatively flat compared to the same period of the prior year. The slight increase in revenue resulted from a favorable impact of foreign exchange rate variations of \$1.2 million for this segment, partially offset by a small decrease in domestic sales.

Gross profit

Gross profit increased to 64.5% of net sales for the quarter ended December 31, 2004, compared to 62.0% in the comparable period in the prior year primarily due to lower manufacturing costs and a shift in product mix towards our higher margin segments. Gross profit for aesthetic and general surgery products improved to 76.2% of net sales, or \$48.1 million for the three-month period ending December 31, 2004, up from 70.9%, or \$38.9 million of net sales in the comparable period in the prior year. This 5.3% increase in gross profit as a percentage of net sales is primarily attributable to favorable pricing on raw materials and overall manufacturing efficiencies at our Texas and Netherlands facilities. Gross profit for surgical urology products improved to 55.4% of net sales for the quarter ended December 31, 2004, compared to 53.5% of net sales in the same period in the prior year. This improvement is primarily due to favorable impact of currency fluctuation and, to a lesser degree, increased sales of women's health products, which have a higher gross margin than most other products in this segment. Gross profit for healthcare products decreased to 47.0% of net sales for the quarter ended December 31, 2004, compared to 51.5% of net sales for the quarter ended December 31, 2003. This decrease is primarily due to certain manufacturing inefficiencies at our foreign manufacturing facilities and lower average selling prices to our international distributors. For the fiscal year ending March 31, 2005, we expect overall gross profit to be in the range of 62% to 64% of net sales.

Selling, General and Administrative

Selling, general and administrative expenses were \$45.4 million, or 37.6% of net sales for the quarter ended December 31, 2004, compared to \$40.6 million or 38.1% for the comparable quarter in the prior year. The increased dollar amount for the period is primarily due to expenses of approximately \$1.2 million related to our recently launched direct-to-consumer television advertising program, an increase of approximately \$1.2 million in certain compensation expenses associated with achieving certain operating targets, and to a lesser extent, higher regulatory expenses related to our silicone gel PMA filing and the effect of foreign currency fluctuations on expenses incurred at our foreign operations. For the fiscal year ending March 31, 2005, we expect sales, general and administrative expense to be in the range of 35% to 37% of net sales.

Research and Development

Research and development expenses for the quarter ended December 31, 2004 were \$8.1 million compared to \$7.2 million a year ago, approximately 6.7% and 6.8% of net sales, respectively. Research and development spending for the quarter ended December 31, 2004 was primarily to support key strategic product development programs including our silicone gel breast implant PMA, the botulinum toxin program, the Hyalite dermal filler program, and the continued development of automated manufacturing technologies. We expect the level of spending on research and development activities to be in the range of 7% to 8% of net sales for the fiscal year ending March 31, 2005.

Interest and Other Income and Expense

Interest expense increased approximately \$1.0 million to \$1.3 million for the quarter ended December 31, 2004, compared to \$.4 million in the same period of the prior year. This increase is due to the additional interest on our \$150 million in convertible subordinated notes issued in December 2003, carrying a coupon of 2 ³/₄%. The remaining interest expense is interest on balances outstanding under our foreign lines of credit. Other income increased due to a one-time gain of approximately \$0.5 million relating to insurance proceeds received to cover lost sales margin on inventory that was damaged.

Income Taxes

The effective rate of corporate income taxes for the three-months ended December 31, 2004, was 32.3% as compared to 31.8% for the comparable period in the prior year. We expect our effective tax rate to be in the range of 32% to 33% for the fiscal year ending March 31, 2005.

Net Income and Earnings Per Share

Net income for the quarter ended December 31, 2004 increased 30% to \$16.3 million, from \$12.5 million in the comparable period

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in the prior year. Diluted earnings per share increased 31% to \$0.34 for the quarter, compared to a restated \$0.26 for the same period last year. As required by EITF 04-8, we have retroactively restated all diluted earnings per share figures from December 2003, the date of issuance of the convertible subordinated notes. The effect of share repurchases was offset by the dilutive effect to earnings per share following the adoption of the EITF, which required the inclusion, for calculation purposes, of additional shares that are contingently

issuable. As a result of our stock repurchase program, we have fewer shares outstanding, resulting in a positive impact on the year-over-year quarterly comparison of diluted earning per share.

For the nine-month period ended December 31, 2004 compared to the nine-month period ended December 31, 2003.

Sales

Sales increased 15.4%, or \$46.9 million to \$351.8 million for the nine months ended December 31, 2004, compared to \$304.9 million for the same period in the prior year. Foreign exchange rate movements, primarily the strengthening of the Euro, had a favorable year-to-year impact on international sales of \$9.4 million for the nine-month period.

Sales by Principal Product Line Nine Months Ended December 31,

(in thousands)	2004	2003	Percent Change
Aesthetic & General Surgery Products	\$ 183,047	\$ 157,523	16.2%
Surgical Urology Products	94,167	78,513	19.9%
Clinical & Consumer Healthcare Products	74,598	68,835	8.4%
	\$ 351,812	\$ 304,871	15.4%

Sales of aesthetic and general surgery products increased 16.2%, or \$25.5 million to \$183.0 million for the nine-month period ended December 31, 2004, compared to \$157.5 million for the same period in the prior year. Approximately \$2.3 million of the increase is attributable to the favorable impact of foreign exchange rates and the balance is due to organic growth in unit sales.

Sales of breast implants increased \$19.2 million or 14% to \$158.5 million for the nine-months ended December 31, 2004, compared to \$139.4 million for the same period in the prior year. Body contouring product sales increased 19% to \$13.3 million for the nine-month period ended December 31, 2004, from \$11.2 million for the comparable period in the prior year. Increases in body contouring product sales are primarily attributable to increased liposuction procedure volume as awareness and acceptance of this procedure increases. Other product sales increased by 61% to \$11.2 million for the nine-months ended December 31, 2004, compared to \$7.0 million the same period in the prior year, primarily as a result of increased revenue from physician participation in our "Extreme Mentor" direct-to-consumer television advertising program and revenue from Inform Solutions, now known as Mentor Solutions, which was acquired in October 2003.

Sales of surgical urology products increased 19.9%, or \$15.7 million to \$94.2 million for the nine-month period ended December 31, 2004, compared to \$78.5 million for the same period in the prior year. The increase in sales was primarily attributable to a \$6.5 million increase in sales of our women's health products primarily from our ObTape[®] sling product, introduced in the United States during August 2003, and a \$7.1 million increase in sales of our disposable urinary care products, primarily due to beneficial impacts of currency fluctuation. Brachytherapy product sales increased 8% to \$11.6 million for the nine-months ended December 31, 2004, compared to \$10.7 million for the same period in the prior year as a result of higher unit sales. Foreign exchange rate fluctuations favorably impacted surgical urology product sales by \$4.0 million.

Sales of clinical and consumer healthcare products increased by 8.4%, or \$5.8 million, to \$74.6 million for the nine-month period ended December 31, 2004, compared to \$68.8 million for the same period in the prior year. Sales of our catheter products increased \$4.3 million or 12% to \$40.3 million for the nine-month period ended December 31, 2004, from \$36.0 million for the same period of the prior year. Sales of other disposable homecare and ostomy products increased 5% to \$34.3 million for the nine-month period ended December 31, 2004, from \$32.8 million in the comparable period of the prior year. This increase resulted from a shift to our premium product categories, which have higher pricing, as well as a favorable impact of foreign exchange rate variations of \$3.0 million for this segment.

Gross profit

Gross profit for the nine-months ended December 31, 2004, improved to 63.8% of net sales from 62.1% for the same period in the prior year primarily due to lower manufacturing costs and a shift in product mix towards our higher margin products. Gross profit for

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aesthetic and general surgery products improved to 75.1% of net sales, or \$137.4 million, for the nine-month period ending December 31, 2004, up from \$112.9 million, or 71.7% of net sales, in the comparable nine-month period in the prior year. This increase in gross profit as a percentage of net sales is primarily attributable to favorable pricing on raw materials and manufacturing efficiencies at our Texas and Netherlands facilities. Gross profit for surgical urology products for the nine-month period ended December 31, 2004 improved to 54.4% of net sales

compared, to 52.9% of net sales for the same period in the prior year. The improvement in the gross profit percentage is primarily due to increased sales of women's health products, which have a higher gross margin than most other products in this segment, and the licensing of our trans-obturator method patent. Gross profit for clinical and consumer healthcare products for the nine-month period ended December 31, 2004 decreased to 48.2% of net sales, compared to 50.9% in the prior year. This decrease is due to certain manufacturing inefficiencies at our foreign manufacturing facilities and lower average selling prices to our international distributors.

Selling, General and Administrative

Selling, general and administrative expense increased to 36.7% of net sales, or \$129.2 million for the nine-month period ended December 31, 2004, compared to 36.1% or \$110.2 million in the comparable period of the prior year. The increase for this nine-month period is due to increases in a number of items. They include an increase of approximately \$2.0 million in certain compensation expenses associated with achieving specific operating targets, higher legal expenses of approximately \$1.6 million due to settlement gains recognized during the prior year nine-month period, as well as increased litigation expenses related to recently concluded litigation, our recently launched direct to consumer television advertising program of approximately \$1.5 million, and recent acquisitions of approximately \$1.2 million. In addition, to a lesser extent, higher regulatory expense related to the silicone gel PMA filing, increased costs associated with Sarbanes-Oxley compliance, and increased support of sales and marketing contributed to the year over year increase. The increase in general and administrative expense was partially offset by lower product warranty and product liability expenses of approximately \$0.8 million.

Research and Development

Research and development expenses for the nine-month period ended December 31, 2004 decreased from 7.4% to 7.0% as a percent of net sales, and was \$24.6 million compared to \$22.5 million for the comparable period in the prior year. Research and development spending primarily supports key strategic product development programs, including our silicone gel breast implant PMA, the botulinum toxin program, the Hyalite dermal filler program, and the continued development of automated manufacturing technologies. During the first quarter of fiscal 2005, we recorded a \$0.8 million charge related to the termination of a brachytherapy development project and related automated manufacturing equipment.

Interest and Other Income and Expense

Interest expense for the nine-month period ended December 31, 2004 increased to \$4.0 from \$0.7 million in the comparable period in the prior year. Approximately \$3.1 million of the expense relates to the \$150 million in convertible subordinated notes issued in December 2003 with a coupon of 2 ³/₄%. The remaining interest expense is interest on balances outstanding under our foreign lines of credit. Other income includes a one-time gain of approximately \$0.5 million relating to insurance proceeds received to cover lost sales margin on finished goods inventory that was damaged.

Income Taxes

The effective rate of corporate income taxes for the nine-months ended December 31, 2004 was 32.0% compared to 31.8% for the comparable period in the prior year.

Net Income and Earnings Per Share

Net income for the nine-month period ended December 31, 2004 increased 16.8% to \$46.5 million from \$39.8 million in the comparable period in the prior year. Diluted earnings per share increased 19.5% to \$0.98 for the nine-month period compared to a restated \$0.82 for the comparable period last year. As required by EITF 04-8, we have retroactively restated all diluted earnings per share figures from December 2003, the date of issuance of our convertible subordinated notes. The effect of share repurchases was offset by the dilutive effect to earnings per share following the adoption of EITF which required the inclusion, for calculation purposes, of additional shares that are contingently issuable. As a result of our stock repurchase program, we have fewer shares outstanding, resulting in a positive impact on the year over year nine-month comparison of diluted earnings per share.

LIQUIDITY AND CAPITAL RESOURCES

Our balance sheet reflected cash, cash equivalents and short-term marketable securities of \$62.7 million at December 31, 2004, compared to \$118.4 million at March 31, 2004. During the first quarter of fiscal 2005, we invested \$25 million of cash into long-term marketable securities, primarily Federal Home Loan Bank and Federal National Mortgage Association notes, to increase our interest income on our cash reserves. Our cash provided by operating activities and the proceeds of our convertible notes has been our primary source of funds. Cash from operating activities is expected to continue to be our primary source of cash. Our working capital was \$155 million at December 31, 2004, compared to \$198 million at March 31, 2004. We generated \$66.5 million of cash from operating activities during the nine-months ended December 31, 2004, compared to \$47.2 million during the same period the previous year. Approximately \$6.7 million of the increase was attributable to higher net income, \$2.9 million was attributable to additional amortization and depreciation expense, \$2.8 million was attributable to additional tax benefit from the exercise of stock options and \$1.5 million was attributable to non-cash losses on asset disposals for the nine-month period ended December 31, 2004. Increased accounts receivable collection activities provided \$4.8 million in additional cash flow from operations for the nine-months ended December 31, 2004, compared to the same period in the prior year.

During the nine-months ended December 31, 2004, we invested approximately \$6.8 million in property and equipment, primarily for production equipment purchases. We anticipate additional investments of approximately \$3 million during the remainder of fiscal 2005 to continue facility improvements and to purchase production equipment.

We receive cash from the exercise of employee stock options. Employee stock option exercises provided \$9.0 million of cash during the nine-months ended December 31, 2004 compared to \$6.9 million in the same period the previous year. Proceeds from the exercise of employee stock options will vary from period to period based primarily upon fluctuations in the market value of our common shares relative to the exercise price of such options, among other factors.

We have a stock repurchase program, primarily to offset the dilutive effect of our employee stock option program, to provide liquidity to the market, and to reduce the overall number of shares outstanding. All shares repurchased under the program are retired and are no longer deemed to be outstanding. During the quarter ended December 31, 2004, 2.3 million shares were repurchased for \$79.8 million. The December repurchase included the repurchase of 2.25 million shares from VA Partners, LLC, who was at the time, our largest shareholder. Mr. Jeff Ubben, a managing member of VA Partners, LLC, is a member of our Board of Directors. The transaction was at market prices and pre-approved by our Audit Committee. At December 31, 2004, 1.3 million shares remained authorized for repurchase. The timing of repurchases is subject to market conditions, cash availability, and blackout periods during which we are restricted from repurchasing shares. There is no guarantee that shares authorized for repurchase by the Board will ultimately be repurchased.

In January 2001, we completed the acquisition of the assets of South Bay Medical, LLC. The total consideration included \$2 million in cash, 470,586 restricted shares of our common stock having a fair market value of \$4 million, and up to \$13.6 million to be paid in cash or our common stock over the next several years. During the quarter ended December 31, 2004, we determined that certain purchase price payments to South Bay Medical related to future sales of workstations were no longer probable, and accordingly we decreased the estimated future payments due under the acquisition agreement by \$10.4 million and concurrently decreased the intangible assets related to the acquired technology by the same amount. The combined adjustments had no effect on net income. These future payments are recorded as an acquisition obligation payment liability of \$0.9 million at December 31, 2004.

In December 2001, we entered into several agreements with Prosurg, Inc. to purchase certain patent rights and to secure a supply of product. The total consideration included \$2.0 million in cash and \$1.7 million in short and long-term payments due over the next several years. The future payments have been recorded as an acquisition obligation liability of \$2.0 million, due over the next several years, based on the achievement of certain milestones.

On September 9, 2003, we entered into several transactions to acquire from AMI, LLC, the exclusive license, marketing and distribution rights for certain product technology, and intellectual property rights, as well as a related supply agreement with Prosurg, Inc. We have paid \$4.5 million in cash and issued 133,630 restricted shares of our common stock valued at fair market value of \$3 million. We anticipate making additional payments of \$3.0 million upon the completion of certain developmental and regulatory milestones, expected to be achieved over the next several years.

On December 22, 2003, we completed an offering of \$150 million of convertible subordinated notes due January 1, 2024 pursuant to Rule 144A under the Securities Act of 1933. The notes bear interest at 2¾% per annum and are convertible into shares of our common stock at an adjusted conversion price of \$29.25 per share and are subordinated to all existing and future senior debt. Concurrent with the issuance of the convertible subordinated notes, we entered into a convertible bond hedge and warrants transactions with respect to our common stock, the exposure for which is held by Credit Suisse First Boston LLC for a net cash payment of \$18.5 million. Both the bond hedge and the warrants transactions may be settled at our option either in cash or net shares and expire January 1, 2009. The convertible bond hedge and warrants transactions combined are intended to reduce the potential dilution from conversion of the notes by effectively increasing the conversion price per share to approximately \$39.43.

In September 2004, the Board of Directors increased our quarterly dividend rate from \$.15 per share to \$.17 per share. It is our intent to continue to pay dividends for the foreseeable future subject to, among other things, Board approval, cash availability, debt restrictions and alternative cash needs. At the current annual dividend rate of \$.68 per share, the aggregate annual dividend would be approximately \$28 million.

We had a secured line of credit for borrowings up to \$25 million ("Credit Agreement"), which accrued interest at the prevailing prime rate or 1.75% over LIBOR, at our discretion. The Credit Agreement expired in September 2004 and we are currently negotiating a new line of credit agreement. The Credit Agreement included certain covenants that, among other things, limited the dividends we could pay and required maintenance of certain levels of tangible net worth and debt service ratios. At December 31, 2004, we had three commercial letters of credit totaling \$2.0 million.

In addition, in February 2001, we established several lines of credit with local foreign lenders to facilitate operating cash flow needs at our foreign subsidiaries. These unsecured credit lines are at market rates of interest, are guaranteed by us, and total \$7.7 million, of which \$3.7 million was outstanding, and \$4.0 million was available at December 31, 2004.

In fiscal 2002, we established a line of credit of \$7.1 million to finance the construction of a new facility in Leiden, the Netherlands. The borrowings accrue interest at EURIBOR plus 0.75% and are secured by the new facility and other assets in the Netherlands. At December 31, 2004, \$5.1 million was outstanding and \$2.0 million was available under this line of credit.

At December 31, 2004, our total short-term borrowings under all lines of credit were \$8.8 million and the weighted-average interest rate was 3.7%. The total amount of additional borrowings available to us under all lines of credit was \$6.0 million and \$28.1 million at December 31, 2004 and March 31, 2004, respectively.

We enter into various product and intellectual property acquisitions and business combinations. In connection with some of these activities, we agree to make payments to third parties when specific milestones are achieved, such as receipt of regulatory approvals or achievement of performance or operational targets.

We do not have any off-balance sheet arrangements that are currently material or reasonably likely to be material to our financial position or results of operations.

Our principal source of liquidity at December 31, 2004 consisted of \$63 million in cash, cash equivalents and short-term marketable securities, plus \$32 million of highly liquid marketable securities accounted for as long term assets, plus \$6 million available under our existing lines of credit. We believe that funds generated from operations, our cash, cash equivalents and marketable securities and funds available under line of credit agreements will be adequate to meet our working capital needs and capital expenditure investment requirements and commitments for the foreseeable future. However, it is possible that we may need to raise additional funds to finance unforeseen requirements or to consummate acquisitions of other business, products or technologies. Additional funds could be raised by selling equity or debt securities to the public or to selected investors, or by borrowing money from financial institutions. In addition, even though we may not need additional funds, we may still elect to sell additional equity or debt securities or obtain credit facilities for other reasons. We may not be able to obtain additional funds on terms that would be favorable to us, or at all. If funds are raised by issuing additional equity securities or convertible debt securities, the ownership percentage of existing shareholders would be reduced. In addition, the equity or debt securities issued by us may have rights, preferences or privileges senior to those of our common stock.

Risk Factors

Forward-Looking Information Under the Private Securities Litigation Reform Act of 1995

The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. The Act was designed to encourage companies to provide prospective information about them without fear of litigation. The prospective information must be identified as forward-looking and must be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statements. The statements about our business, plans, strategies, intentions, expectations and prospects contained throughout this document are based on current expectations. These statements are forward-looking and actual results may differ materially from those predicted as of the date of this report in the forward-looking statements, which involve risks and uncertainties. In addition, past financial performance is not necessarily a reliable indicator of future performance and investors should not use historical performance to anticipate results or future period trends. We undertake no obligation to revise or update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

Our business faces many risks. The risks described below may not be the only risks we face. Additional risks that we do not yet know of or that we currently think are immaterial may also impair our business operations. If any of the events or circumstances described in the following risks actually occurs, our business, financial condition or results of operations could suffer and the trading price of our common stock or our convertible notes could decline. You should consider the following risks before deciding to invest in our common stock or convertible notes.

Significant product liability claims or product recalls may force us to pay substantial damage awards and other expenses that could exceed our accruals and insurance coverage.

The manufacture and sale of medical devices exposes us to significant risk of product liability claims. In the past, and currently, we have had a number of product liability claims relating to our products, and we may be subject to additional product liability claims in the future, some of which may have a negative impact on our business. If a product liability claim or series of claims is brought against us for uninsured liabilities or in excess of our insurance coverage, our business could suffer. Some manufacturers that suffered such claims in the past have been forced to cease operations or even to declare bankruptcy. Additionally, we could experience a material design or manufacturing failure in our products, a quality system failure, other safety issues, or heightened regulatory scrutiny that would warrant a recall of some of our products and could result in exposure to additional product liability claims.

We are subject to substantial government regulation, which could have a material adverse affect on our business.

The production and marketing of our products and our ongoing research and development activities, including pre-clinical testing and clinical trial activities, are subject to extensive regulation and review by numerous governmental authorities both in the U.S. and abroad. Most of the medical devices we develop must undergo rigorous pre-clinical and clinical testing and an extensive regulatory approval process before they can be marketed. Certain of our products are required to undergo review by a panel of outside experts, which makes a recommendation to the FDA as to whether the product(s) should be approved. This panel of experts, who are outside of the FDA, may or may not agree that the product should be approved. This process makes it longer, more difficult and more costly to bring our products to market, and we cannot guarantee that any of our unapproved products will be approved or how long it may take for any one particular product to be approved. The pre-marketing approval process can be particularly expensive, uncertain and lengthy, and a number of devices for which the FDA approval has been sought by other companies have never been approved for marketing. In addition to testing and approval procedures, extensive regulations also govern manufacturing, packaging, labeling, storage, distribution, record-keeping, and advertising and marketing procedures. If we do not comply with applicable regulatory requirements, such violations could result in non-approval, suspensions of clinical trials, suspension or withdrawal of regulatory approvals, product recalls, civil penalties and criminal fines, product seizures, operating restrictions, injunctions, and criminal prosecution.

Delays in, withdrawal, or rejection of the FDA or other government entity approval(s) of our products may also adversely affect our business. Such delays, withdrawals, or rejections may be encountered due to, among other reasons, government or regulatory delays, lack of demonstrated safety or efficacy during clinical trials, safety issues, manufacturing issues, slower than expected rate

of patient recruitment for clinical trials, inability to follow patients after treatment in clinical trials, inconsistencies between early clinical trial results and results obtained in later clinical trials, varying interpretations of data generated by clinical trials, or changes in regulatory policy or requirements in the U.S. and abroad.

In the U.S., there has been a continuing trend toward more stringent FDA requirements in the areas of product approval and enforcement, causing medical device manufacturers to experience longer research and development timelines, longer approval cycles, greater risk and uncertainty, and higher expenses. Internationally, there is a risk that we may not be successful in meeting the quality standards or other certification requirements. Even if regulatory approval of a product is granted, such approval may entail limitations on uses for which the product