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CURATIVE HEALTH SERVICES INC
Form 10-Q
May 10, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities
Exchange Act of 1934

For the quarterly period ended March 31, 2004

OR

Transition report pursuant to Section 13 or 15 (d) of the Securities
Exchange Act of 1934

Commission File Number: 000-50371

Curative Health Services, Inc.
(Exact name of registrant as specified in its charter)

MINNESOTA
(State or other jurisdiction of
incorporation or organization)

51-0467366
(I.R.S. Employer
Identification Number)

150 Motor Parkway
Hauppauge, New York 11788
(631) 232-7000

(Address and phone number of principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports
required to be filed by Section 13 or 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter period that the
registrant was required to file such reports), and (2) has been subject to such
filing requirements for the past 90 days: Yes 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 April 30, 2004, there were 12,919,294 shares of the Registrant's
Common Stock, \$.01 par value, outstanding.

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Part I Financial Information

Item 1. Financial Statements

Curative Health Services, Inc. and Subsidiaries
CONDENSED CONSOLIDATED INCOME STATEMENTS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended March 31	
	2004	2003
Revenues:		
Products	\$ 59,085	\$ 50,450
Services	6,473	7,570
	65,558	58,020
Total revenues		

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Costs and operating expenses:		
Cost of product sales	46,824	37,387
Cost of services	2,927	3,478
Selling, general and administrative	10,018	11,058
	-----	-----
Total costs and operating expenses	59,769	51,923
	-----	-----
Income from operations	5,789	6,097
Interest income	6	2
Interest expense	(616)	(487)
	-----	-----
Income before income taxes	5,179	5,612
Income taxes	2,046	2,217
	-----	-----
Net income	\$ 3,133	\$ 3,395
	=====	=====
Net income per common share, basic	\$.24	\$.28
	=====	=====
Net income per common share, diluted	\$.23 (i)	\$.25 (i)
	=====	=====
Weighted average common shares, basic	12,925	12,206
	=====	=====
Weighted average common shares, diluted	13,717	13,920
	=====	=====

(i) Calculated under the "as if converted" method. See Note 2.

See accompanying notes

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Curative Health Services, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	March 31, 2004	December 31, 2003
	-----	-----
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,506	\$ 1,072
Accounts receivable, net	58,216	55,217
Inventories	9,684	11,237
Prepays and other current assets	1,501	4,270

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Deferred tax assets	2,984	2,984
	-----	-----
Total current assets	73,891	74,780
Property and equipment, net	7,651	7,890
Intangibles subject to amortization, net	1,284	1,463
Intangibles not subject to amortization (trade names)	682	682
Goodwill	148,030	147,895
Other assets	1,359	1,228
	-----	-----
Total assets	\$ 232,897	\$ 233,938
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 30,586	\$ 28,892
Accrued expenses	9,494	11,502
Deferred taxes	1,007	1,007
Current portion of long-term liabilities	7,871	7,911
	-----	-----
Total current liabilities	48,958	49,312
Long-term liabilities	34,448	39,599
Deferred taxes	1,307	1,307
	-----	-----
Total long-term liabilities	35,755	40,906
Stockholders' equity:		
Common stock	128	127
Additional paid in capital	116,412	115,082
Retained earnings	33,251	30,118
Notes receivable - stockholders	(1,607)	(1,607)
	-----	-----
Total stockholders' equity	148,184	143,720
	-----	-----
Total liabilities and stockholders' equity	\$ 232,897	\$ 233,938
	=====	=====

See accompanying notes

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Curative Health Services, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended	
	March 31,	
	2004	2003
	-----	-----
OPERATING ACTIVITIES:		
Net income	\$ 3,133	\$ 3,395
Adjustments to reconcile net income to net cash provided by operating activities:		

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Depreciation and amortization	888	570
Provision for doubtful accounts	602	1,025
Amortization of deferred financing fees	60	15
Changes in operating assets and liabilities, net of effects from Specialty Pharmacy acquisitions:		
Accounts receivable	(3,548)	(3,928)
Inventories	1,553	(728)
Prepays and other	392	517
Accounts payable and accrued expenses	(855)	5,242
	-----	-----
NET CASH PROVIDED BY OPERATING ACTIVITIES	2,225	6,108
INVESTING ACTIVITIES:		
Proceeds from Investment in Accordant Health Services, Inc.	2,327	--
Specialty Pharmacy acquisitions, net of cash acquired	(547)	(4,656)
Purchases of property and equipment	(470)	(1,812)
	-----	-----
NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES	1,310	(6,468)
FINANCING ACTIVITIES:		
Shares repurchased and retired	--	(1,524)
Proceeds from exercise of stock options	162	1,777
Repayments of long-term liabilities	(3,263)	(538)
	-----	-----
NET CASH USED IN FINANCING ACTIVITIES	(3,101)	(285)
	-----	-----
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	434	(645)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,072	2,643
	-----	-----
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 1,506	\$ 1,998
	=====	=====
SUPPLEMENTAL INFORMATION		
Interest paid	\$ 531	\$ 428
	=====	=====
Income taxes paid	\$ 143	\$ 115
	=====	=====

See accompanying notes

Curative Health Services, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

The condensed consolidated financial statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements for the year ended December 31, 2003 and notes

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thereto contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2004.

Stock Based Compensation Plans

The Company grants options for a fixed number of shares to employees and directors with an exercise price equal to the fair value of the shares at the date of grant. The Company accounts for stock option grants under the recognition and measurement principles of Accounting Principles Board ("APB") No. 25, "Accounting for Stock Issued to Employees," and related Interpretations because the Company believes the alternate fair value accounting provided for under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," requires the use of option valuation models that were not developed for use in valuing employee stock options. Under APB No. 25, because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recorded.

The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation for the three months ended March 31, 2004 and 2003 (in thousands, except per share data):

	Three Months Ended March 31,	
	2004	2003
Net income	\$ 3,133	\$ 3,395
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	1,175	1,132
Pro forma net income	\$ 1,958	\$ 2,263
Earnings per share:		
Basic - as reported	\$.24	\$.28
Basic - pro forma	.15	.19
Diluted - as reported	\$.23(i)	\$.25(i)
Diluted - pro forma	.15(i)	.17(i)

(i) Calculated under the "as if converted" method. See Note 2.

Curative Health Services, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 2. Net Income per Common Share

Net income per common share, basic, is computed by dividing the net income by the weighted average number of common shares outstanding. Net income per common share, diluted, is computed by dividing adjusted net income (see below) by the weighted average number of shares outstanding plus dilutive common share equivalents. The following table sets forth the computation of weighted average shares, basic and diluted, used in determining basic and diluted earnings per

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share (in thousands):

	Three Months Ended March 31,	
	2004	2003
Weighted average shares, basic	12,925	12,206
Effect of dilutive stock options and convertible notes	792	1,714
	13,717	13,920
Weighted average shares, diluted	13,717	13,920
	=====	=====

Adjusted net income and net income per common share, diluted, for the three months ended March 31 were computed as follows (in thousands, except per share data):

	Three Months Ended March 31,	
	2004	2003
Net income, as reported	\$ 3,133	\$ 3,395
Add back interest related to convertible notes, net of tax	32	65
Adjusted net income	\$ 3,165	\$ 3,460
	=====	=====
Net income per common share, diluted	\$.23	\$.25
	=====	=====
Weighted average shares, diluted	13,717	13,920
	=====	=====

In accordance with SFAS No. 128, "Earnings Per Share," net income per common share, diluted, for the three months ended March 31, 2004 and 2003 was calculated under the "as if converted" method, which requires adding shares related to convertible notes that have no contingencies to the denominator for diluted earnings per share and adding to net income, the numerator, tax effected interest expense relating to those convertible notes.

Note 3. Specialty Pharmacy Acquisitions

On February 3, 2003, the Company acquired MedCare, Inc. ("MedCare"), a specialty pharmacy with locations in Alabama, Mississippi and West Virginia. The purchase price for MedCare was \$6.3 million. A final purchase price allocation based on fair market value of acquired assets and liabilities has been completed.

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Curative Health Services, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 3. Specialty Pharmacy Acquisitions (continued)

On April 23, 2003, the Company acquired the assets and specialty pharmacy business of All Care Medical, Inc. ("All Care"), a Louisiana-based Synagis(R) pharmacy. The purchase price of All Care was \$2.1 million. A final purchase price allocation based on fair market value of acquired assets and liabilities

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has been completed.

On June 9, 2003, the Company acquired certain assets of Prescription City, Inc. ("Prescription City"), a Spring Valley, New York, specialty pharmacy business specializing in the provision of chemotherapy and cancer drugs. Prescription City's service area includes southern New York and some areas of northeastern Pennsylvania. Drug therapies provided by Prescription City include chemotherapy, HIV/AIDS drugs, Synagis(R), IVIG, pain management and Remicade(R). The purchase price for Prescription City was \$17.5 million. Fair market valuations have not yet been finalized and, as such, the allocation of the purchase price is preliminary, pending receipt of a formal valuation and the outcome of the Company's indemnification claim.

As previously disclosed, a search warrant issued by a U.S. Magistrate Judge, Southern District of New York, relating to a criminal investigation was executed on November 4, 2003 at the Company's Prescription City pharmacy in Spring Valley, New York. The Government has informed the Company that it is not a target of the investigation. The Company was served with the search warrant on Tuesday, November 4, 2003 while it was conducting its own compliance review at the Spring Valley pharmacy. The Company intends to cooperate fully with the U.S. Attorney's Office in its investigation. Based on information known as of November 5, 2003, the Company terminated Paul Frank, the former principal shareholder of Prescription City. The Company also hired outside counsel in connection with this investigation. Certain assets of Prescription City were purchased by the Company in June 2003. The purchase was structured as an asset purchase with the Company being provided indemnifications, representations and warranties by the seller. The Company has filed a complaint in the Southern District of New York against Paul Frank and Prescription City, and such complaint has not yet been served on those parties.

The acquisitions described above (collectively the "Specialty Pharmacy acquisitions") were consummated for purposes of expanding the Company's Specialty Pharmacy Services business and were accounted for using the purchase method of accounting. The accounts of the Specialty Pharmacy acquisitions and related goodwill and intangibles are included in the accompanying condensed consolidated balance sheets. The operating results of the Specialty Pharmacy acquisitions are included in the accompanying condensed consolidated income statements from the dates of acquisition.

Unaudited pro forma amounts for the three months ended March 31, 2003, assuming the Specialty Pharmacy acquisitions had occurred on January 1, 2003 are as follows (in thousands, except per share data):

Revenues	\$ 67,378
Net income	\$ 4,553
Net income per share, diluted	\$.33

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Curative Health Services, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 3. Specialty Pharmacy Acquisitions (continued)

The pro forma operating results shown above are not necessarily indicative of operations in the periods following acquisitions.

Note 4. Segment Information

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The Company adheres to the provisions of SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." The Company has two reportable segments: Specialty Pharmacy Services and Specialty Healthcare Services. In its Specialty Pharmacy Services business unit, the Company purchases various biopharmaceutical products from suppliers and then contracts with insurance companies and other payors, as well as retail pharmacies, to provide direct-to-patient distribution of, and other support services, including education, reimbursement and the provision or coordination of injection or infusion services related to, these biopharmaceutical products, including Synagis(R) for the prevention of respiratory syncytial virus. Revenues from Synagis(R) sales for the three months ended March 31, 2004 were approximately \$23.0 million. As respiratory syncytial virus occurs primarily during the winter months, the major portion of the Company's Synagis(R) sales may be higher during the first and fourth quarters of the calendar year which may result in significant fluctuations in the Company's quarterly operating results.

In its Specialty Healthcare Services business unit, the Company contracts with hospitals to manage outpatient Wound Care Center(R) programs. The Company evaluates segment performance based on income from operations. For the three months ended March 31, 2004, management estimated that corporate general and administrative expenses allocated to the reportable segments were 59% for Specialty Pharmacy Services and 41% for Specialty Healthcare Services. Intercompany transactions are eliminated to arrive at consolidated totals.

The following tables present the results of operations and total assets of the reportable segments of the Company at and for the three months ended March 31, 2004 and 2003 (in thousands):

	At and for the three months ended March 31, 2004		
	Specialty Pharmacy	Specialty Healthcare	Total
Revenues	\$ 59,085	\$ 6,473	\$ 65,558
Income from operations	\$ 5,440	\$ 349	\$ 5,789
Total assets	\$ 210,095	\$ 22,802	\$ 232,897
	At and for the three months ended March 31, 2003		
	Specialty Pharmacy	Specialty Healthcare	Total
Revenues	\$ 50,450	\$ 7,570	\$ 58,020
Income from operations	\$ 5,580	\$ 517	\$ 6,097
Total assets	\$ 153,156	\$ 43,194	\$ 196,350

Curative Health Services, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 5. Employee and Facility Termination Costs

In July 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," which nullifies Emerging Issues Task Force Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal

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activities initiated after December 31, 2002. SFAS No. 146 establishes fair value as the objective for initial measurement of liabilities related to exit or disposal activities and requires that such liabilities be recognized when incurred.

In the first quarter of 2003, the Company consolidated its pharmacy operations in California which resulted in the termination of a total of 25 employees and the vacating of a leased facility. The Company recorded a charge of \$1.6 million in the same period related to this activity.

The following provides a reconciliation of the related accrued costs associated with the pharmacy consolidation at and for the three months ended March 31, 2004 (in thousands):

	At and for the three months ended March 31, 2004			
	Beginning Balance	Costs Charged To Expense	Costs Paid or Otherwise Settled	Ending Balance
	-----	-----	-----	-----
Employee termination costs	\$ 39	\$ --	\$ --	\$ 39
Facility termination costs	431	--	60	371
	-----	-----	-----	-----
	\$ 470	\$ --	\$ 60	\$ 410
	=====	=====	=====	=====

In 2004, the Company expects to pay out approximately \$0.3 million of these accrued costs and the remainder in subsequent years.

Note 6. Changes in Capital Structure

During the first three months of 2004, the Company had the following significant changes in capital structure:

Notes Converted into Common Stock. In January 2004, certain selling shareholders of Infinity Infusion Care, Ltd. ("Infinity") exercised their rights under convertible notes and converted approximately \$1.2 million of such notes into 72,715 shares of the Company's common stock.

Note 7. Subsequent Event

On April 23, 2004 the Company acquired Critical Care Systems, Inc. ("CCS") for a total consideration of approximately \$150 million in cash. CCS is a leading national provider of specialty infusion pharmaceuticals and related comprehensive clinical services. CCS focuses on delivering four principal therapies: hemophilia clotting factor, IVIG, Total Parenteral Nutrition (TPN) and anti-infective therapies. These core therapies represent the essential components of Specialty Infusion and account for approximately 75% of CCS's revenues.

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The purchase price was paid from the proceeds of an offering of \$185 million aggregate principal amount of 10.75% senior notes due 2011 offered in a private placement to eligible purchasers pursuant to Rule 144A and Regulation S under the Securities Act of 1933. Concurrent with the transaction closing, the Company also completed the refinancing of its existing credit facility with GE Healthcare Financial Services, a unit of GE Commercial Finance, as agent and lender to a \$40 million senior secured revolving credit facility to support permitted acquisitions and future working capital and general corporate needs.

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

Overview

Curative Health Services, Inc. ("Curative" or the "Company"), through its two business units, Specialty Pharmacy Services and Specialty Healthcare Services, seeks to deliver high-quality care and clinical results that result in high patient satisfaction for patients experiencing serious or chronic medical conditions.

Curative's Specialty Pharmacy Services business unit provides biopharmaceutical products to patients with chronic and critical disease states and related clinical services to assist these patients with their intensive disease management needs. The Company purchases various biopharmaceutical products from suppliers and then contracts with insurance companies and other payors, as well as retail pharmacies, to provide direct-to-patient distribution of these products. In addition to distribution, the Company also provides other support services, including education, reimbursement and provision or coordination of injection or infusion services, related to these biopharmaceutical products. The biopharmaceutical products distributed and the injection or infusion therapies offered by the Company are used by patients with chronic or severe conditions such as hemophilia, immune system disorders, respiratory syncytial virus, cancer, rheumatoid arthritis, hepatitis C, multiple sclerosis or growth hormone deficiency. Examples of biopharmaceuticals products used by the Company's patients include hemophilia clotting factor, intravenous immune globulins (or "IVIG"), MedImmune Inc.'s Synagis(R) and Centocor, Inc.'s Remicade(R). As of March 31, 2004, the Company had 218 payor contracts and 23 retail pharmacy contracts and provided services or products in at least 40 states. The Specialty Pharmacy Services business unit provides services directly to patients and caregivers and delivers its products via overnight mail or courier and through its retail pharmacies.

The following provides approximate percentages of Specialty Pharmacy Services' patient revenues for the three months ended March 31, 2004 and for the year ended December 31, 2003:

	March 31, 2004	December 31, 2003
	-----	-----
Private Payors	41.4%	42.5%
Medicaid	54.6%	51.0%
Medicare	4.0%	6.5%

Curative's Specialty Healthcare Services business unit is a leading disease management company in chronic wound care management. The Specialty Healthcare Services business unit manages, on behalf of hospital clients, a nationwide

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network of Wound Care Center(R) programs that offer a comprehensive range of services for treatment of chronic wounds. The Company's Wound Management Program(TM) consists of diagnostic and therapeutic treatment procedures that are designed to meet each patient's specific wound care needs on a cost-effective basis. The Company's treatment procedures are designed to achieve positive results for wound healing based on significant experience in the field. The Company maintains a proprietary database of patient results that it has collected since 1988 containing over 450,000 patient cases. The Company's treatment procedures, which are based on extensive patient data, have allowed the Company to achieve an overall rate of healing of approximately 85% for patients completing therapy. As of March 31, 2004, the Wound Care Center network consisted of 92 outpatient clinics located on or near campuses of acute care hospitals in 30 states.

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Critical Accounting Policies and Estimates

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses the Company's condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, management evaluates its estimates and judgments, including those related to revenue recognition, bad debts, inventories, income taxes and intangibles. Management bases its 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 believes the following critical accounting policies, among others, affect its more significant judgments and estimates used in the preparation of its condensed consolidated financial statements:

Revenue recognition. Specialty Pharmacy Services' revenues are recognized, net of any contractual allowances, when the product is shipped to a patient, retail pharmacy or a physician's office, or when the service is provided. Specialty Healthcare Services' revenues are recognized after the management services are rendered and are billed monthly in arrears.

Trade receivables: Considerable judgment is required in assessing the ultimate realization of receivables, including the current financial condition of the customer, age of the receivable and the relationship with the customer. The Company estimates its allowances for doubtful accounts using these factors. If the financial condition of the Company's customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required. In circumstances where the Company is aware of a specific customer's inability to meet its financial obligations (e.g., bankruptcy filings), a specific reserve for bad debts is recorded against amounts due to reduce the receivable to the amount the Company reasonably believes will be collected. For all other customers, the Company has reserves for bad debt based upon the total accounts receivable balance. As of March 31, 2004, the Company's reserve for accounts receivable was approximately 7% of total receivables.

Inventories: Inventories are carried at the lower of cost or market on a first

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in, first out basis. Inventories consist of high cost biopharmaceutical and pharmaceutical products that, in many cases, require refrigeration or other special handling. As a result, inventories are subject to spoilage or shrinkage. On a quarterly basis, the Company performs a physical inventory and determines whether any shrinkage or spoilage adjustments are needed. Although the Company believes its inventories balances at March 31, 2004 are reasonably accurate, there can be no assurances that spoilage or shrinkage adjustments will not be needed in the future. The recording of any such reserve may have a negative impact on the Company's operating results.

Deferred tax assets: The Company has approximately \$3 million in deferred tax assets at March 31, 2004 to offset against future income and approximately \$2.3 million in deferred tax liabilities. The Company does not have a valuation allowance against its assets as it believes it is more likely than not that the tax assets will be realized. The Company has considered future income expectations and prudent tax strategies in assessing the need for a valuation allowance. In the event the Company determines in the future that it needs to record a valuation allowance, an adjustment to deferred tax assets would be charged against income in the period of determination.

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Goodwill and intangibles: Goodwill represents the excess of purchase price over the fair value of net assets acquired. Intangibles consist of the separately identifiable intangibles, such as pharmacy and customer relationships and covenants not to compete. Effective January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which requires goodwill and intangible assets with indefinite lives no longer be amortized but rather be reviewed annually, or more frequently if impairment indicators arise, for impairment. Separable intangible assets that are not deemed to have an indefinite life will continue to be amortized over their useful lives. In assessing the recoverability of the Company's goodwill and intangibles, the Company must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or assumptions change in the future, the Company may need to record an impairment charge for these assets. An impairment charge would reduce operating income in the period it was determined that the charge was needed.

Key Performance Indicators

The following provides a summary of some of the key performance indicators that may be used to assess the Company's results of operations. These comparisons are not necessarily indicative of future results (dollars in thousands).

	For the three Months Ended March 31,			
	2004	2003	\$ Change	% Change
Specialty Pharmacy revenues	\$ 59,085	\$ 50,450	\$ 8,635	17%
Specialty Healthcare revenues	6,473	7,570	(1,097)	(14%)
Total revenues	\$ 65,558	\$ 58,020	\$ 7,538	13%
Specialty Pharmacy revenues to total	90%	87%		
Specialty Healthcare revenues to total	10%	13%		
Total	100%	100%		

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Specialty Pharmacy gross margin	\$ 12,261	\$ 13,063	\$ (802)	(6%)
Specialty Healthcare gross margin	3,546	4,092	(546)	(13%)
	-----	-----	-----	
Total gross margin	\$ 15,807	\$ 17,155	\$ (1,348)	(8%)
Specialty Pharmacy gross margin %	21%	26%		
Specialty Healthcare gross margin %	55%	54%		
Total gross margin %	24%	30%		
Specialty Pharmacy - SG&A	\$ 3,712	\$ 5,843	\$ (2,131)	(36%)
Specialty Healthcare - SG&A	1,036	2,120	(1,084)	(51%)
Corporate - SG&A	5,270	3,095	2,175	70%
	-----	-----	-----	
Total SG&A	\$ 10,018	\$ 11,058	\$ (1,040)	(9%)
Operating margin	\$ 5,789	\$ 6,097	\$ (308)	(5%)
Operating margin %	9%	11%		

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Results of Operations

Revenues. The Company's revenues for the first quarter of 2004 increased 13% to \$65.6 million compared to \$58 million for the first quarter of the prior fiscal year. The increase in revenues was the result of the Specialty Pharmacy acquisitions the Company completed in 2003, as well as internal growth in Synagis(R) revenues, offset by a reduction in service revenues in the Specialty Healthcare business unit.

Product revenues, attributed entirely to the Specialty Pharmacy Services business unit, increased \$8.6 million, or 17%, to \$59.1 million in the first quarter of 2004 from \$50.5 million in the first quarter of 2003. The increase in revenues for the first three months of 2004 compared to the same period in 2003 was primarily attributable to the Specialty Pharmacy acquisitions completed in 2003 and organic growth of approximately 12.1% in IVIG, infusables and injectables and 9.7% growth in pro forma Synagis(R) revenues, offset by a 1.2% decline in hemophilia revenues. Product revenues for the first quarter of 2004 and 2003 included the following:

	Three Months Ended March 31,			
	2004		2003	
	In millions	% of Specialty Pharmacy Revenues	In millions	% of Specialty Pharmacy Revenues
	-----	-----	-----	-----
Hemophilia	\$ 27.7	47%	\$ 28.6	57%
IVIG, infusables and injectables(1)	4.8	8%	4.0	8%
Synagis(R)	23.0	39%	16.8	33%
Oncology	1.6	3%	--	--
Other(2)	2.0	3%	1.1	2%
	-----	-----	-----	-----
Total Specialty Pharmacy revenues	\$ 59.1	100%	\$ 50.5	100%
	=====	=====	=====	=====

(1) Includes IVIG, Remicade(R) and growth hormone products

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- (2) Other includes, but is not limited to, products such as oral medications, Avonex(R), Rebetrone(R), Betaseron(R), Rebif(R) and Enbrel(R)

As respiratory syncytial virus occurs primarily during the winter months, the major portion of the Company's Synagis(R) sales will be recorded in the first and fourth quarters of the calendar year which may result in significant fluctuations in the Company's quarterly operating results.

Service revenues, attributed entirely to the Specialty Healthcare Services business unit, decreased 14% to \$6.5 million in the first quarter of 2004 from \$7.6 million in the first quarter of 2003. The service revenues decrease of \$1.1 million for the first quarter 2004 was attributed to contract renegotiations resulting in lower average revenues per program and the conversion over the last 12 months of 4 under arrangement programs to management service programs where revenues are lower. For the first quarter of 2004, the Company signed six new Wound Care Management contracts and no contracts were terminated. The continued termination, non-renewal or renegotiations of a material number of management contracts or the inability to sign new contracts could result in a continued decline in the Company's Specialty Healthcare Services business unit revenue.

Cost of Product Sales. Cost of product sales, attributed entirely to the Specialty Pharmacy Services business unit, increased 25% to \$46.8 million in the first quarter 2004 from \$37.4 million in the first quarter of 2003. The increase of \$9.4 million for the first quarter of 2004 was attributed to the internal growth of Synagis(R) revenues and the inclusion of product revenues from the Specialty Pharmacy acquisitions completed in 2003. As a percentage of product sales, cost of product sales for the first

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quarter of 2004 was 79% compared to 74% for the same period in 2003, primarily the result of a higher percentage of Synagis(R) revenues in 2004 which typically carry a lower gross margin than the Company's other products.

Cost of Services. Cost of services, attributed entirely to the Specialty Healthcare Services business unit, decreased 16% to \$2.9 million in the first quarter of 2004 from \$3.5 million in the first quarter of 2003. The decrease of \$0.6 million for the first quarter compared to the same period in 2003 was attributed to the conversion over the last 12 months of 4 under arrangement programs to management service programs where expenses are lower. As a percentage of service revenues, cost of services for the first quarter of 2004 was 45% compared to 46% for the same period in 2003.

Selling, General and Administrative. Selling, general and administrative expenses decreased \$1 million, or 9%, to \$10 million for the first quarter of 2004 from \$11.1 million for the same period in 2003. For the first quarter of 2004, selling, general and administrative expenses consisted of \$3.7 million related to the Specialty Pharmacy Services business, \$1 million related to the Specialty Healthcare Services business and \$5.3 million related to corporate services, including \$0.2 million in charges related to litigation costs of Prescription City and integration costs of the CCS acquisition. The decrease of \$1 million was due to the inclusion of \$0.2 million in charges in the first three months of 2004 compared to \$2.7 million in charges for the same period of 2003, offset by increases due to acquisitions completed in 2003 and growth in corporate departments to support the acquisitions. The charges incurred in 2003 were related to costs of the Company's consolidation of its pharmacy operations and severances related to executive departures. As a percentage of revenues, selling, general and administrative expenses were 15% in the first quarter of 2004 compared to 19% percent for same period in 2003.

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Net Income. Net income was \$3.1 million, or \$.23 per diluted share, in the first quarter of 2004 compared to \$3.4 million, or \$.25 per diluted share, in the first quarter of 2003.

Liquidity and Capital Resources

Working capital was \$24.9 million at March 31, 2004 compared to \$25.5 million at December 31, 2003. Total cash and cash equivalents at March 31, 2004 was \$1.5 million. The ratio of current assets to current liabilities was 1.5 to 1 at March 31, 2004 and December 31, 2003.

Cash flows provided by operating activities for the three months ended March 31, 2004 totaled \$2.2 million, primarily attributable to the \$3.1 million in net income, \$0.9 million in depreciation and amortization and a decrease of \$1.6 million in inventories, offset by an increase of \$2.9 million in accounts receivable, net, and a decrease of approximately \$0.9 million in accounts payable and accrued expenses.

Cash flows provided by investing activities totaled \$1.3 million attributable to proceeds of approximately \$2.3 million from Accordant Health Services, offset by \$0.5 million cash used in acquisitions and \$0.5 million used in fixed asset purchases.

Cash flows used in financing activities totaled \$3.1 million attributable to \$3.3 million used in repayments of debt obligations offset by approximately \$0.2 million in proceeds from the exercise of stock options.

During the first three months of 2004, the Company experienced a net increase in accounts receivable of \$3 million attributed to the Specialty Pharmacy acquisitions, growth in specialty pharmacy revenues and an increase in accounts receivable days outstanding. Days sales outstanding were 84 days at March 31, 2004, as compared to 78 days at December 31, 2003. At March 31, 2004, days sales outstanding for the

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Specialty Pharmacy Services business unit was 84 days and for the Specialty Healthcare Services business unit, days sales outstanding was 72 days.

As of March 31, 2004, the Company's current portion of long-term liabilities of \$7.9 million included \$4 million representing the current portion of the Company's borrowings from its commercial lender, \$2 million representing the current portion of the Department of Justice ("DOJ") obligation, \$0.9 million representing the current portion of a convertible note payable used in connection with the purchase of Apex Therapeutic Care, Inc. ("Apex") in February 2002 and \$1 million representing the note payable used in connection with the purchase of certain assets of Prescription City in June 2003. At March 31, 2004, the Company's long-term liabilities of \$34.4 million included \$1.5 million related to the DOJ obligation, a \$1.9 million promissory note representing the long-term portion of the convertible note used in the purchase of Apex, \$3 million in a convertible note payable related to the purchase of Home Care of New York, Inc. in October 2002 and \$28 million in borrowed funds from the Company's commercial lender.

The Company's current portion of long-term liabilities and long-term liabilities decreased \$5.2 million to \$42.3 million at March 31, 2004 compared to \$47.5 million at December 31, 2003. The 11% decrease is due to the conversion of \$1.2 million related to the Infinity note, principal payments and a lower revolver balance.

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The Company's longer term cash requirements include working capital for the expansion of its Specialty Pharmacy Services business and for acquisitions. Other cash requirements are anticipated for capital expenditures in the normal course of business, including the acquisition of software, computers and equipment related to the Company's management information systems. As of March 31, 2004, the Company had a \$3.5 million obligation, payable over approximately two years, to the DOJ related to the settlement of its litigation previously disclosed, as well as bank debt and convertible and promissory notes totaling \$38.8 million payable over various periods through 2007. In April 2004, the Company completed the acquisition of CCS for total consideration of approximately \$150 million in cash. The purchase price was paid with the proceeds from an offering of \$185 million aggregate principal amount of 10.75% senior notes due 2011 offered in a private placement to eligible purchasers pursuant to Rule 144A and Regulation S under the Securities Act of 1933. Concurrent with the transaction closing, the Company also completed the refinancing of its existing credit facility with GE Healthcare Financial Services, a unit of GE Commercial Finance, as agent and lender to a \$40 million senior secured revolving credit facility to support permitted acquisitions, and future working capital and general corporate needs. Upon completion of the CCS transaction, the Company had approximately \$24.5 million of availability under its revolving credit facility. The Company expects that, based on its current business plan, its expected operating cash flow and existing credit facilities will be sufficient to meet working capital needs and a minimal number of acquisitions. Any acquisitions of substantial size will require the Company to either increase its credit facilities, issue equity or offer some combination of both debt and equity.

Cautionary Statement

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements include statements regarding intent, belief or current expectations of the Company and its management. These forward-looking statements are not guarantees of future performance and involve a number of risks and uncertainties that may cause the Company's actual results to differ materially from the results discussed in these statements. Factors that might cause such differences include, but are not limited to, those described under the heading, "Critical Accounting Policies and Estimates" herein, or those described in Exhibit 99.1 to this Form 10-Q and other factors described in the Company's future filings with the SEC.

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Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company does not have operations subject to risks of material foreign currency fluctuations, nor does it use derivative financial instruments in its operations or investment portfolios. The Company places its investments in instruments that meet high credit quality standards, as specified in the Company's investment policy guidelines. The Company does not expect any material loss with respect to its investment portfolio or exposure to market risks associated with interest rates. The Company is subject to interest rate risk under its current credit facilities.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Under the supervision and with the participation of the Company's management,

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including its Chief Executive Officer and Chief Financial Officer, the Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective in timely alerting them to the material information relating to the Company (or its consolidated subsidiaries) required to be included in the reports the Company files or submits under the Exchange Act.

Changes in Internal Controls

During the fiscal quarter ended March 31, 2004, there has been no change in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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Curative Health Services, Inc. and Subsidiaries

Part II Other Information

Item 1. Legal Proceedings

In the normal course of its business, the Company may be involved in lawsuits, claims, audits and investigations, including any arising out of services or products provided by or to the Company's operations, personal injury claims and employment disputes, the outcome of which, in the opinion of management, will not have a material adverse effect on the Company's financial position or results of operations.

As previously disclosed, a search warrant issued by a U.S. Magistrate Judge, Southern District of New York, relating to a criminal investigation was executed on November 4, 2003 at the Company's Prescription City pharmacy in Spring Valley, New York. The Government has informed the Company that it is not a target of the investigation. The Company was served with the search warrant on Tuesday, November 4, 2003 while it was conducting its own compliance review at the Spring Valley pharmacy. The Company intends to cooperate fully with the U.S. Attorney's Office in its investigation. Based on information known as of November 5, 2003, the Company terminated Paul Frank, the former principal shareholder of Prescription City. The Company also hired outside counsel in connection with this investigation. Certain assets of Prescription City were purchased by the Company in June 2003. The purchase was structured as an asset purchase with the Company being provided indemnifications, representations and warranties by the seller. The Company has filed a complaint in the Southern District of New York against Paul Frank and Prescription City, and such complaint has not yet been served on those parties.

Item 2. Changes in Securities and Use of Proceeds

(c) (ii) Conversion of Notes

In January 2004, the Company issued an aggregate of 72,715 shares of common stock upon the conversion of \$1.2 million of convertible notes held by certain former shareholders of Infinity Infusion Care, Ltd. which was acquired by the Company in June 2002. The issuance of the shares was affected without registration under the Securities Act in reliance on Section 3(9) of that Act as an exchange of

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securities by an issuer with its existing security holders where no commission or other remuneration was paid or given directly or indirectly for soliciting such exchange.

Item 5. Other Information

- (b) On February 12, 2004, the Company adopted Corporate Governance Guidelines which contains procedures by which security holders may recommend nominees to the Company's Board of Directors. Under these guidelines, shareholders desiring to recommend nominations to the Board are required to submit such recommendations by written notice to the secretary of the Company. Such notice must be received at the Company's principal executive offices at least 60 days before the date that is one year after the prior year's meeting. Such notice shall set forth (i) the name and record address of both the stockholder and of any beneficial owner on whose behalf the nomination is being made ("Beneficial Owner"); (ii) the class and number of shares of the Company owned by both the stockholder and by any Beneficial Owner; (iii) the name, age, business address, principal occupation or employment and residence address of each nominee; and (iv) the class and number of shares owned by each nominee. The Company's

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Governance Committee shall consider any recommendations made by the shareholders in the manner prescribed as it considers appropriate, and evaluate any nominees so recommended in accordance with the standards for director candidates set forth in the Company's Corporate Governance Guidelines.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

- | | |
|--------------|---|
| Exhibit 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) (Section 302 Certification), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 31.2 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) (Section 302 Certification), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. ss.1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. ss.1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 99.1 | Risk Factors |

The Company has excluded from the exhibits filed with this report instruments defining the rights of holders of long-term convertible debt of the Company where the total amount of the securities authorized under such instruments does not exceed 10 % of its total assets. The Company

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hereby agrees to furnish a copy of any of these instruments to the SEC upon request.

(b) Form 8-K

Form 8-K filed February 25, 2004, furnishing under Item 12 a press release announcing the Company's results of operations and financial condition for the completed fiscal quarter and full-year ended December 31, 2003.

Form 8-K filed March 9, 2004, reporting under Item 5 a press release announcing the Company's entering into a definitive agreement to acquire the capital stock of Critical Care Systems, Inc.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: May 10, 2004

Curative Health Services, Inc.
(Registrant)

/s/ Joseph Feshbach

Joseph Feshbach
Chief Executive Officer and Chairman
(Principal Executive Officer)

/s/ Thomas Axmacher

Thomas Axmacher
Chief Financial Officer
(Principal Financial and Accounting
Officer)

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