

MENTOR CORP /MN/
Form 10-Q
November 14, 2001

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

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

Transition Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934

For the Quarterly Period September 30, 2001

Commission File Number 0-7955

Mentor Corporation
(Exact name of registrant as specified in its charter)

Minnesota 41-0950791

(State of Incorporation) (I.R.S. Employer Identification Number)

201 Mentor Drive, Santa Barbara, California

93111
(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number: (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 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

The number of shares outstanding for each of the Issuer's classes of common stock as of November 13, 2001 was:

Common Shares, \$.10 par value 23,359,115 shares

Mentor Corporation

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None

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Mentor Corporation
Condensed Consolidated Balance Sheets
(Unaudited)

| | | |
|--|----------------------|-----------|
| | September 30, | March 31, |
|--|----------------------|-----------|

| (dollars in thousands) | 2001 | 2001 |
|---|------------|------------|
| <u>Assets</u> | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 63,741 | \$ 63,854 |
| Marketable securities | 851 | 584 |
| Accounts receivable, net | 55,245 | 57,427 |
| Inventories | 47,120 | 46,721 |
| Deferred income taxes | 10,167 | 10,116 |
| Prepaid expenses and other | 11,716 | 9,331 |
| Total current assets | 188,840 | 188,033 |
| Property and equipment, net | 51,991 | 51,149 |
| Intangibles, net | 36,127 | 37,773 |
| Goodwill, net | 6,484 | 6,547 |
| Long-term marketable securities and investments | 5,678 | 5,704 |
| Other assets | 1,592 | 1,631 |
| | \$ 290,712 | \$ 290,837 |

See Notes to Condensed Consolidated Financial Statements

Mentor Corporation
Condensed Consolidated Balance Sheets
(Unaudited)

| (dollars in thousands) | | |
|---|---------------|-----------|
| <u>Liabilities and shareholders' equity</u> | September 30, | March 31, |
| Current liabilities: | 2001 | 2001 |
| Accounts payable | \$ 16,733 | \$ 14,731 |
| Warranty and related reserves | 14,239 | 12,062 |
| Accrued compensation | 12,430 | 11,062 |
| Sales returns | 4,911 | 4,913 |
| Current portion of South Bay Medical purchase price | 3,675 | 3,675 |
| Income taxes payable | - | 2,992 |
| Short-term bank borrowings | 3,861 | 16,624 |
| Accrued royalties | 742 | 1,150 |
| Dividends payable | 723 | 710 |
| Other accrued liabilities | 7,349 | 7,653 |
| Total current liabilities | 64,663 | 75,572 |
| | | |
| | | |

| | | |
|--|-------------------|------------|
| Deferred income taxes | 8,448 | 8,268 |
| Long-term accrued liabilities | 10,836 | 10,691 |
| Commitments and contingencies | | |
| Shareholders' equity: | | |
| Common Shares, \$.10 par value: | | |
| Authorized - 50,000,000 shares; Issued and outstanding-- | | |
| 23,505,773 shares at September 30, 2001; | | |
| 23,671,770 shares at March 31, 2001; | 2,351 | 2,367 |
| Capital in excess of par value | 102 | 7,625 |
| Foreign currency translation adjustments | (4,238) | (4,911) |
| Net unrealized gains on securities | 616 | 629 |
| Retained earnings | 207,934 | 190,596 |
| | 206,765 | 196,306 |
| | \$ 290,712 | \$ 290,837 |

See Notes to Condensed Consolidated Financial Statements

Mentor Corporation
Consolidated Statements of Income
(Unaudited)

| | Three Months Ended | |
|---------------------------------------|--------------------|-----------|
| | September 30, | |
| | 2001 | 2000 |
| (in thousands, except per share data) | | |
| Net sales | \$ 74,347 | \$ 61,038 |
| Costs and expenses: | | |
| Cost of sales | 31,618 | 23,946 |
| Selling, general, and administrative | 25,703 | 23,886 |
| Research and development | 5,170 | 4,914 |
| Restructuring charge | - | 1,050 |
| | 62,491 | 53,796 |
| Operating income | 11,856 | 7,242 |
| Interest expense | (198) | (21) |
| Interest income | 699 | 1,109 |
| Other income, net | 96 | 657 |
| Income before income taxes | 12,453 | 8,987 |
| Income taxes | 3,964 | 2,964 |

| | | |
|--|-----------------|----------|
| Net income | \$ 8,489 | \$ 6,023 |
| | | |
| Basic earnings per share | \$ 0.35 | \$ 0.25 |
| Diluted earnings per share | \$ 0.34 | \$ 0.25 |
| | | |
| See notes to consolidated financial statements | | |

Mentor Corporation
Consolidated Statements of Income
(Unaudited)

| | Six Months Ended | |
|--|-------------------|------------|
| | September 30, | |
| (in thousands, except per share data) | 2001 | 2000 |
| Net sales | \$ 155,491 | \$ 128,573 |
| Costs and expenses: | | |
| Cost of sales | 64,349 | 49,647 |
| Selling, general, and administrative | 53,745 | 50,326 |
| Research and development | 11,242 | 9,186 |
| Restructuring charge | - | 1,050 |
| | 129,336 | 110,209 |
| Operating income | 26,155 | 18,364 |
| Interest expense | (507) | (86) |
| Interest income | 1,301 | 2,238 |
| Other income, net | 596 | 833 |
| Income before income taxes | 27,545 | 21,349 |
| Income taxes | 8,766 | 6,993 |
| Net income | \$ 18,779 | \$ 14,356 |
| | | |
| Basic earnings per share | \$ 0.79 | \$ 0.60 |
| Diluted earnings per share | \$ 0.76 | \$ 0.59 |
| | | |
| See notes to consolidated financial statements | | |

Mentor Corporation
Condensed Consolidated Statements of Cash Flows
Six Months Ended September 30, 2001 and 2000
(Unaudited)

| (in thousands) | 2001 | 2000 |
|----------------|------|------|
|----------------|------|------|

| | | |
|---|-----------|-----------|
| <u>Cash From Operating Activities:</u> | | |
| Net cash provided by operating activities | \$ 30,455 | \$ 12,544 |
| <u>Cash From Investing Activities:</u> | | |
| Purchases of property, equipment and intangibles | (6,584) | (3,060) |
| Purchases and sales of marketable securities | (222) | 7,500 |
| Other, net | 18 | 149 |
| Net cash used for investing activities | (6,788) | (4,589) |
| <u>Cash From Financing Activities:</u> | | |
| Proceeds from exercise of stock options | 5,425 | 937 |
| Dividends paid | (1,430) | (1,203) |
| Borrowings under line of credit agreement | 1,362 | 6,000 |
| Repayments under line of credit agreement | (14,132) | (6,000) |
| Repurchase of common stock | (15,091) | (25,174) |
| Net cash used for financing activities | (23,866) | (25,440) |
| Effect of currency exchange rate changes on cash and cash equivalents | 86 | - |
| Increase in cash and cash equivalents | (113) | (8,307) |
| Cash and cash equivalents at beginning of period | 63,854 | 24,313 |
| Cash and cash equivalents at end of period | \$ 63,741 | \$ 16,006 |

See notes to consolidated financial statements

Mentor Corporation
Notes to Condensed Consolidated Financial Statements
September 30, 2001

Note A - Summary of Significant Accounting Policies

The accompanying unaudited condensed consolidated financial statements 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 of normal recurring accruals) considered necessary for a fair presentation have been included. Certain amounts recorded in previous periods have been reclassified to conform to the current period presentation. Operating results for the six-months ended September 30, 2001 are not necessarily indicative of the results that may be expected for the year ended March 31, 2002.

The balance sheet at March 31, 2001 has been derived from the audited financial statements at 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.

For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended March 31, 2001.

Note B - Inventories

Inventories at September 30, 2001 and March 31, 2001 consisted of:

| (in thousands) | September 30, | March 31, |
|-----------------|---------------|-----------|
| Raw materials | \$ 6,665 | \$ 7,212 |
| Work in process | 6,315 | 9,564 |
| Finished goods | 34,140 | 29,945 |
| | \$ 47,120 | \$ 46,721 |

Note C - Long-Term Marketable Securities

The Company considers its marketable securities available-for-sale as defined in Statement Financial Accounting Standards No. 115. 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 any material differences between estimated fair values, based on quoted market prices, and the costs of securities in the investment portfolio as of September 30, 2001 and March 31, 2001. The Company's short-term marketable securities consist primarily of commercial paper and municipal bonds that are of limited credit risk and have contractual maturities of less than two years.

The Company's long-term marketable securities and investments includes the Company's equity investments in its manufacturing partners, Intracel Corporation and North American Scientific, Inc. (NASI), and shares of Paradigm Medical Industries, Inc. (Paradigm). The Intracel Corporation investment is valued and recorded at \$3 million (cost of \$6 million), as quoted market prices are not available. During the year ended March 31, 2000, the Company recorded a \$3 million write down as a charge to other income related to its investment in Intracel Corporation. The equity interests in NASI, the Company's manufacturing partner under an exclusive agreement for the distribution of brachytherapy seeds for the treatment of prostate cancer, and in Paradigm are recorded at an aggregate fair market value of \$2,668,000 (cost of \$1,720,000) and \$2,704,000 (cost of \$1,737,000) based upon quoted stock market prices at September 30, 2001 and March 31, 2001, respectively. The unrealized gain of \$616,000 and \$629,000, net of taxes of \$332,000 and \$338,000, at September 30, 2001 and March 31, 2001, respectively, is reported as a separate component of shareholders' equity.

Note D - Comprehensive Income

The components of comprehensive income are listed below:

| (in thousands) | Three Months Ended | | Six Months Ended | |
|---|--------------------|----------|------------------|-----------|
| | September 30, | | September 30, | |
| | 2001 | 2000 | 2001 | 2000 |
| Net income | \$ 8,489 | \$ 6,023 | \$ 18,779 | \$ 14,356 |
| Foreign currency translation adjustment | 3,367 | (728) | 673 | (1,224) |

| | | | | |
|--|-----------|----------|-----------|----------|
| Unrealized (losses) on marketable securities and investments | (492) | (514) | (13) | (1,600) |
| Comprehensive income | \$ 11,364 | \$ 5,809 | \$ 19,439 | \$11,532 |

Note E - 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 Contour Genesis/ΦONT> Υλτρασονιχ εθυιπμεντ προδυχτ λινε αλονγ ωιτη εθυιπμεντ ανδ δισποσαβλεσ φορ τραδιτιοναλ λιποσυχτιον. Τησ συργιχαλ υρολογησ σεγμεντ ινχλυδεσ πενιλε ιμπλαντσ, συργιχαλ ινχοντινενηε προδυχτσ ανδ βραχηηπτηεραηπ σεεδσ φορ τηε τρεατμεντ οφ προστατε χανχερ. Τηε χλινιχαλ ανδ χονσυμερ ηεαλτηχαρε σεγμεντ ινχλυδεσ χατηετερσ ανδ οτηερ προδυχτσ φορ τηε μαναγεμεντ οφ υριναρησ ινχοντινενηε ανδ ρετεντιον.

Selected financial information for the Company's reportable segments is as follows:

| | Three Months Ended September 30, | | Six Months Ended September 30, | |
|----------------------------------|-------------------------------------|-----------|-----------------------------------|------------|
| | 2001 | 2000 | 2001 | 2000 |
| (in thousands) | | | | |
| Revenues | | | | |
| Aesthetic and General Surgery | \$ 36,388 | \$ 35,997 | \$ 79,326 | \$ 77,473 |
| Surgical Urology | 22,535 | 13,657 | 46,182 | 27,654 |
| Clinical and Consumer Healthcare | 15,424 | 11,384 | 29,983 | 23,446 |
| Total Consolidated Revenues | \$ 74,347 | \$ 61,038 | \$ 155,491 | \$ 128,573 |

| | Three Months Ended September 30, | | Six Months Ended September 30, | |
|----------------------------------|-------------------------------------|----------|-----------------------------------|-----------|
| | 2001 | 2000 | 2001 | 2000 |
| (in thousands) | | | | |
| Operating income | | | | |
| Aesthetic and General Surgery | \$ 9,456 | \$ 5,709 | \$ 22,232 | \$ 16,243 |
| Surgical Urology | 1,269 | 1,867 | 2,272 | 3,569 |
| Clinical and Consumer Healthcare | 3,160 | 1,912 | 5,705 | 4,377 |

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| | | | | |
|------------------------------|-----------|----------|-----------|-----------|
| Total Reportable Segments | 13,884 | 9,489 | 30,210 | 24,189 |
| Corporate operating expenses | (2,028) | (2,247) | (4,055) | (5,825) |
| Interest expense | (198) | (21) | (507) | (86) |
| Interest income | 700 | 1,109 | 1,302 | 2,238 |
| Other income (loss) | 97 | 657 | 597 | 833 |
| Income before income taxes | \$ 12,455 | \$ 8,987 | \$ 27,547 | \$ 21,349 |

| (in thousands) | September 30, 2001 | March 31, 2001 |
|----------------------------------|-----------------------|-------------------|
| Identifiable assets | | |
| Aesthetic and General Surgery | \$ 82,335 | \$ 84,363 |
| Surgical Urology | 84,678 | 82,152 |
| Clinical and Consumer Healthcare | 42,798 | 41,302 |
| Total reportable segments | \$ 209,811 | 207,817 |
| Corporate and other | 80,900 | 83,020 |
| Consolidated assets | \$ 290,711 | \$ 290,837 |

Note F - Earnings Per Share

A reconciliation of 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:

| | Three Months Ended September 30, | | Six Months Ended September 30, | |
|---|-------------------------------------|--------|-----------------------------------|--------|
| | 2001 | 2000 | 2001 | 2000 |
| Average outstanding shares: Basic | 23,982 | 23,646 | 23,876 | 23,790 |
| Shares issuable through options | 837 | 576 | 798 | 618 |
| Average common shares outstanding: Diluted | 24,819 | 24,222 | 24,674 | 24,408 |

Certain employee stock options have been excluded from the computation of diluted earnings per share because their effective would be anti-dilutive.

Note G - Interim Reporting

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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. The fiscal year end remains March 31. 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 quarter end are shown below:

| | <u>Fiscal 2002</u> | <u>Fiscal 2001</u> |
|----------------|--------------------|--------------------|
| First Quarter | June 29, 2001 | June 30, 2000 |
| Second Quarter | September 28, 2001 | September 29, 2000 |
| Third Quarter | December 28, 2001 | December 29, 2000 |

Note H - Effects of Recent Accounting Pronouncements

In September 2000, the Emerging Issues Task Force (EITF) reached a final consensus on EITF Issue 00-10, "Accounting for Shipping and Handling Fee and Costs," which addresses the classification of outbound shipping and handling costs and the related revenue. The Company adopted EITF 00-10 in the fourth quarter of fiscal year 2001 resulting in a reclassification of outgoing freight revenue from a deduction from cost of sales to an increase in revenue. In accordance with the guidance, sales and cost of goods sold for all prior periods presented have been reclassified. As a result of the reclassification, for the six months ended September 30, 2000 sales and cost of sales increased by \$1,439,000 to \$128,573,000 and \$49,647,000 respectively. These reclassifications had no effect on reported gross profit or results of operations.

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement No. 133 (SFAS 133) "Accounting for Derivative Instruments and Hedging Activities." Subsequently, the FASB issued Statement No. 137, "Accounting for Derivative Instruments and Hedging Activities - Deferral of the Effective Date of FASB Statement No. 133" (SFAS 137) which deferred the effective date of SFAS 133 for one year. The Company adopted SFAS 133 and SFAS 137 in the first quarter of fiscal year 2002. SFAS 133 requires the Company to record all derivatives as assets or liabilities at fair value. Changes in derivative fair values will either be recognized in earnings, offset against changes in the fair value of the related hedged assets, liabilities and firm commitments or, for forecasted transactions, recorded as a component of accumulated other comprehensive income in shareholders' equity until the hedge transactions occur and are recognized in earnings. The ineffective portion of a hedging derivative's change in fair value will depend on a variety of factors, including the extent of the Company's hedging activities, the types of hedging instruments used and the effectiveness of such instruments. Due to the Company's limited use of derivatives and hedging, the adoption of this standard did not have a significant effect on earnings or the financial position of the Company.

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets (SFAS 142), effective for fiscal years beginning after December 15, 2001. Under SFAS 142, goodwill will no longer be amortized but will be subject to annual impairment tests. Other intangible assets will continue to be amortized over their useful lives.

The Company will apply the new rules on accounting for goodwill and other intangible assets beginning in the quarter ending June 30, 2002. The Company will perform the first of the impairment tests of goodwill as of April 1, 2002 and has not yet determined what effect the outcome of these tests will have on the Company's financial statements.

Note I - Event Subsequent to September 30, 2001

Subsequent to September 30, 2001 management became aware that Intracel Corporation filed for protection under Chapter 11 of the Bankruptcy Code. The Company has an investment in the common stock of Intracel Corporation valued and recorded at \$3 million, (cost of \$6 million) as of September 30, 2001. At this time it is not possible to

assess the effect on the valuation of the investment or to what extent, if any, the investment is impaired.

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

Except for the historical information contained herein, the matters discussed in this Management's Discussion contain certain forward-looking statements that involve risk and uncertainty. Such forward-looking statements are characterized by future or conditional verbs and include statements regarding new and existing products, technologies and opportunities, market and industry segment growth and demand and acceptance of new and existing products. Such statements are only predictions and our actual results may differ materially from those anticipated in these forward-looking statements. Factors that may cause such differences include, but are not limited to, increased competition, changes in product demand, changes in market acceptance, new product development, obtaining FDA approval of new and existing products, changes in government regulation, supply of raw materials, changes in reimbursement practices, adverse results of litigation and other risks identified in this Form 10-Q or in other documents filed by the Company with the Securities and Exchange Commission. Specific attention should be directed to the sections entitled "Government Regulation", "Legal Proceedings", and "Factors that May Effect Future Results of Operations" in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2001. The Company assumes no obligation to update forward-looking statements as circumstances change.

RESULTS OF OPERATIONS

Sales

Sales for the three months ended September 30, 2001 increased 22% to \$74 million compared to \$61 million for the same quarter of the prior year. Sales for quarter were negatively affected by the events of September 11, 2001 as air shipments were disrupted and surgeries were postponed or cancelled. The Company estimates that over \$2 million in sales were lost after September 11.

Aesthetic surgery sales totaled \$36.4 million for the quarter, compared to \$36.0 million in the same quarter of the prior year, an increase of 1%. Breast implant sales increased 6% over the prior year but were offset by weakness in Body Contouring (liposuction) and other products. Within breast implant sales, Reconstructive products sales increased 19% over the same period in the prior year, and were offset by an 2% decrease in sales of implants for the larger Augmentation market.

Sales of surgical urology products totaled \$22.5 million for the quarter, an increase of 65% over the \$13.7 million reported for the same quarter in the prior year. Sales of our Suspend sling implant for incontinence increased 1% compared to the same quarter in prior year. Brachytherapy product sales increased by 5%, and penile implant sales increased by 4% from same quarter in prior year. The Porges' product lines acquired in the fourth quarter of fiscal 2001 added substantial volume to this segment and represents the majority of the sales increase.

The clinical and consumer healthcare product line, consisting of urological catheters and other disposables, sales totaled \$15.4 million, an increase of 35% over the \$11.4 million for the same quarter in the prior year. The majority of the increase in sales over the prior year was attributable to the Porges product lines for healthcare acquired in the fourth quarter of fiscal 2001.

For the six months ended September 30, 2001 sales increased 21% from \$128.6 million to \$155.5 million. The majority of the increase in sales over the prior year was attributable to the Porges product lines for surgical urology and home care acquired in the fourth quarter of fiscal 2001. Surgical urology product revenue increased 67% primarily due to the acquisition of the Porges' product lines, and growth in brachytherapy seeds and Suspend Sling. Aesthetic and General surgery products increased 2%, reflecting 8% growth in mammary implant revenues, offset by decreases in body contouring and other revenues. Clinical and Consumer Healthcare revenue increased 28% primarily due to the acquisition of the Porges' product lines and growth in intermittent catheter sales offset by a decrease in external

catheter sales.

| | Sales by Principal Product Line | | | | | |
|--|---|----------|-------------------|---|-----------|-------------------|
| | For The Three Months Ended September 30, | | | For the Six Months Ended September 30, | | |
| | 2001 | 2000 | Percent Change | 2001 | 2000 | Percent Change |
| Aesthetic & General Surgery Products | \$36,388 | \$35,997 | 1.1% | \$79,326 | \$ 77,473 | 2.4% |
| Surgical Urology Products | 22,535 | 13,657 | 65.0% | 46,182 | 27,654 | 67.0% |
| Clinical & Consumer Healthcare Products | 15,424 | 11,384 | 35.5% | 29,983 | 23,446 | 27.9% |
| | \$74,347 | \$61,038 | 21.8% | \$155,491 | \$128,573 | 20.9% |

Cost of Sales

Cost of sales as a percent of net sales for the quarter and six months ended September 30, 2001 were 42.5% and 41.4% compared to 39.2% and 38.6% for the same periods a year ago. The increase were primarily attributable to a shift in the Company's product mix as a result of the acquisition of Porges product lines in the fourth quarter of fiscal 2001. Porges products have a gross margin of approximately 40% and accordingly, have a dilutive effect on the overall margin, which has historically been in excess of 60%. In addition, an increased percentage of total sales are represented by two other products (brachytherapy seeds and the SuspendSling), which are distributed by the Company under alliance agreements. These alliance products generate gross margins of approximately 50%, which is lower than the margin generated by products that are both manufactured and distributed by the Company.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were 34.6% of sales in the quarter compared to 39.1% in the comparable period in the previous year. For the six months ended September 30, 2001, selling, general and administrative expenses were 34.6 % of sales compared to 39.1%. The decrease as a percentage of net sales reflects cost savings from the Company's restructuring of corporate staff during the second and third quarters of fiscal 2001 and the recent acquisition of Porges which has lower rates of selling, general and administrative expenses.

During fiscal 2001, the Company announced a reduction in corporate staff at its headquarters in Santa Barbara as part of a restructuring move to streamline operations and improve efficiency. This program resulted in restructuring charges, primarily severance pay, of \$1.05 million and \$1.35 million, in the second and third quarters of fiscal 2001 respectively.

Research and Development

Research and development expenses as a percent of net sales for the quarter and six months ended September 30, 2001 were 7.0% and 7.2%, respectively, compared to 8.1% and 7.1% for the comparable periods in the previous year.

Development costs related to the Company's automated brachytherapy workstation, accelerated product enhancement projects for existing products and new product development. In May 2000, the Company received FDA approval for saline-filled breast implants and in July 2000, received similar regulatory clearance on our inflatable penile implants. Although the Company has successfully completed these PMAA submissions, the amount of spending on research and development is not expected to decrease as the focus of research and development efforts shifts towards product enhancements and new product development. In addition, the Company is committed to a variety of clinical and laboratory studies in connection with its gel-filled mammary implants and other products.

Interest Expense, Interest Income and Other Income, Net

Interest expense was \$198 thousand in the quarter ended September 30, 2001 compared to \$21 thousand in the same quarter of the previous year. For the six months ended September 2001, interest expense was \$507 thousand compared to \$86 thousand for the comparable period in the prior year. In May 2001, the Company repaid the \$14 million borrowed in February 2001 to temporarily fund its acquisition of Porges. In January 2001 the Company acquired the assets of South Bay Medical LLC. Approximately \$7 million of the purchase price was recorded as a long-term accrued liability at net present value. Imputed interest on this liability is charged to interest expense. This imputed interest, the borrowing to fund the Porges acquisition, and balances outstanding on several lines of credit established to facilitate operating cash flow needs at our foreign subsidiaries accounted for the increase in interest expense over the prior periods.

Interest income for the three months ended September 30, 2001 decreased to \$699 thousand from \$1.1 million. For the six months ended September 2001, interest income was \$1.3 million compared to \$2.2 million for the comparable period in the prior year. The decrease is due to lower cash and marketable security balances, lower prevailing interest rates on short term investments, and a shift in the Company's investment strategy from taxable commercial paper which has a higher pretax yield to tax free municipal bonds and similar investment vehicles which currently have a higher after-tax yield.

Other income, net for the three months ended September 30, 2001 decreased to \$96 thousand from \$657 thousand. For the six months ended September 2001, other income was \$596 thousand compared to \$833 thousand for the comparable period in the prior year. Other income, net primarily includes gains and losses on sales of marketable securities, and foreign currency transaction gains and losses related to the Company's foreign operations. The decrease is primarily attributable to realized gains on sales of marketable securities in the prior year, which have not recurred in fiscal year 2002. During the three months ended September 30, 2001, the Company realized a gain of \$32 thousand on the sale of marketable securities.

Income Taxes

The effective rate of corporate income taxes for the three and six months ended September 2001 is approximately 31.8%, as compared to 33% in the comparable periods in the prior year. The decrease in the effective tax rate from the prior year is a result of a higher proportion of income from foreign operations with lower tax rates and increased tax-exempt interest income.

Net Income

Net income for the three months ended September 30, 2001 increased 41% from \$6.0 million to \$8.5 million. Net income increased 31% from \$14.4 million reported in the previous year to \$18.8 million for the six months ended September 30, 2001. Diluted earnings per share increased 36% to \$.34 for the three month period compared to \$.25 for the comparable period last year. Although the increase in diluted earnings per share is consistent with the increase in sales, much of the improvements in operating results is attributable to reduced spending in selling, general and administrative expenses, including the restructuring charge of \$1.05 million, offset by increases in cost of goods sold, research and development, and interest expense.

LIQUIDITY AND CAPITAL RESOURCES

At September 30, 2001, the Company's working capital was \$124 million compared to \$112 million at March 31, 2001. During the quarter ended September 30, 2001, the Company's liquidity needs have been satisfied principally by cash flow from operations.

The Company generated \$30.5 million of cash from operations during the six months ended September 30, 2001, compared to \$12.5 million the previous year.

During the six months ended September 30, 2001, the Company spent \$6.6 million on purchases of manufacturing equipment and information technology. The Company anticipates investing approximately \$20 million in a facility acquisition, facility upgrades, production equipment and information technology systems in fiscal 2002.

The Company has available to it \$25 million under a secured line of credit. Borrowings accrue interest at the prevailing prime rate or at a premium to LIBOR, at the Company's discretion. The line of credit includes certain covenants that, among others, limit the dividends the Company may pay and require the maintenance of certain levels of tangible net worth and debt service ratios. In February 2001, the Company borrowed \$14.1 million (15 million Euro) to fund the acquisition of Porges S.A. The amount was repaid in May 2001. In addition, there are several lines of credit established to facilitate operating cash flow needs at our foreign subsidiaries. These lines are at market rates of interest, unsecured, guaranteed by Mentor Corporation, and total \$5.2 million. At September 30, 2001, \$3.9 million was outstanding under these foreign lines of credit.

Since 1995, the Company has paid a quarterly cash dividend of \$.025 per share. On February 13, 2001, the Board of Directors approved an increase in the quarterly cash dividend to \$.03 per share, an increase of 20%. At the indicated rate of \$.12 per year, the aggregate annual dividend would equal approximately \$2.8 million.

The Company's Board of Directors has authorized an ongoing stock repurchase program. The objectives of the program, among other items, are to offset the dilutive impact of stock option, provide liquidity to the market and to reduce the overall number of shares outstanding. Repurchases are subject to market conditions and cash availability. During fiscal 2002 to date, the Company repurchased 732 thousand shares for consideration of \$18.7 million. The Company intends to continue the share repurchase program and 1.75 million shares remain authorized for repurchase.

The Company's principal source of liquidity at September 30, 2001 consisted of \$64.6 million in cash, cash equivalents and short-term marketable securities plus \$26 million available under the existing lines of credit. The Company believes that funds generated from operations, its cash, cash equivalents, marketable securities and funds available under its various lines of credit will be adequate to meet its working capital and capital expenditure requirements through fiscal 2002.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

There has been no material changes in the Company's exposure to market risk as reported in Item 7A in the annual report on Form 10-K for the fiscal year ended March 31, 2001.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

In regards to the litigation reported in Item 3 of the annual report on Form 10-K for the fiscal year ended March 31, 2001, there have been no material changes.

Item 2. Changes in Securities

None

Item 3. Defaults Upon Senior Securities

No event constituting a material default has occurred respecting any senior security of the Registrant.

Item 4. Submission of Matters to a Vote of Security Holders

At the Company's 2001 Annual Meeting of Shareholders held on September 14, 2001, the following proposals were presented and approved:

(1) A proposal to elect a Board of Directors of the Company to serve until the next annual meeting, or until their successors are elected, as follows:

| Name of Director | Votes For | Votes Withheld |
|-----------------------|------------|----------------|
| Christopher J. Conway | 20,914,719 | 568,247 |
| Eugene G. Glover | 20,915,269 | 567,697 |
| Walter W. Faster | 20,913,331 | 569,635 |
| Michael Nakonechny | 20,899,089 | 583,877 |
| Dr. Richard W. Young | 20,899,369 | 583,597 |
| Ronald J. Rossi | 20,911,956 | 571,010 |

There were no broker non-votes.

(2) A proposal to approve the Company's Amended 2000 Long-Term Incentive Plan. The proposal received 17,039,570 votes for, and 4,380,042 votes against ratification. There were 63,348 abstentions. There were no broker non-votes.

(3) A proposal to ratify the appointment of Ernst & Young LLP to act as independent auditors of the Company for the fiscal year ending March 31, 2002. The proposal received 21,163,295 votes for, and 292,171 against ratification. There were 27,500 abstentions. There were no broker non-votes.

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

None

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.

MENTOR CORPORATION

(Registrant)

Date: November 13, 2001 By: /s/CHRISTOPHER CONWAY

Christopher J. Conway
President and Chief Executive Officer

Date: November 13, 2001 By: /s/ADEL MICHAEL

Adel Michael
Executive Vice President
Chief Financial Officer