Scott P. Anderson
President & Chief Executive Officer

- Good morning and thanks for taking time to participate in our second quarter earnings conference call.
- Joining me today is Steve Armstrong, our executive vice president and chief financial officer, who will review some highlights of our second quarter performance following my opening remarks.
- Since Regulation FD prohibits us from providing investors with earnings guidance unless we release that information simultaneously, we provided financial guidance for fiscal 2013 in our press release earlier this morning.
- This guidance is subject to a number of risks and uncertainties that could cause Patterson's actual results to vary from our forecasts.
- These risks and uncertainties are discussed in detail in our Annual Report on Form 10-K and our other SEC filings, and we urge you to review this material.
- Turning now to our second quarter results, Patterson reported consolidated sales of $867.2 million for the second quarter of fiscal 2013 ended October 27, an increase of 1% from $856.9 million in the year-earlier period.
- Net income of $45.5 million, or $0.44 per diluted share, compared to $49 million, or $0.43 per diluted share, in the second quarter of fiscal 2012.
- Our earnings were affected primarily by below-plan sales of dental equipment, as well as the absorption of $3.0 million of incremental interest expense related to Patterson's debt issuance in the third quarter of fiscal 2012.
- As I will discuss during the next few minutes, several areas of our business, including dental technology equipment and Webster Veterinary, performed well in the second quarter.
- On balance, however, we are not satisfied with our recent operating results, which did not meet our expectations.
- Patterson Dental, our largest business, reported sales of $549.1 million, which was substantially unchanged from last year's second quarter.
- Within this unit, sales of consumable supplies rose 1%, which was consistent with our internal forecast.
- We believe the consumables market is stable, but until unemployment is significantly reduced and consumer confidence improves, it is unrealistic to expect that the underlying market for consumables can perform much beyond current levels.
- Sales of basic dental equipment, including chairs, units and lighting, were well below forecasted levels, making this product category the primary reason behind our second quarter sales shortfall.
- While we are encouraged that the dental practitioner has been willing to expend funds on technology related products over the past several years, the basic equipment market recovery has been at a much slower pace.
- We continue to work with our customers on investments in their basic operatory infra-structure, however, the predictability of when they will commit to those investments quarter-to-quarter remains volatile.
- Consistent with this pattern, we recorded mid-single digit revenue growth for dental technology products in the second quarter, which partially offset the weakness in basic equipment.
- Total sales of dental equipment and software were down 3% in the second quarter.
- Within our technology category, which is benefiting from the ongoing trend toward the digitization of dentistry, sales of CEREC systems and extra-oral x-ray products were strong during the quarter.
- CEREC demand received a boost from the launch of Omnicam by Sirona Dental Systems at its CEREC 27.5 anniversary event in Las Vegas in August.
- The thousands of dental professionals who attended this event gave Omnicam an overwhelmingly positive reception as a major technological advancement in CAD/CAM technology.
- Omnicam's positive initial reception has subsequently been matched by strong, continuing demand for this next-generation product from both new and existing CEREC customers.
- However, the number of Omnicam systems timely delivered to us during the second quarter was less than anticipated.
- This development constrained Omnicam sales in the second quarter.
- In short, demand for this next-generation system outstripped product availability, which was a risk factor that we mentioned in our last conference call.

- Based on information from Sirona, we expect Omnicam production volumes to ramp up over the next six months.
- I also want to emphasize that since Sirona and Patterson are in complete agreement about wanting to avoid any quality issues on this technologically advanced system, we are not pressuring Sirona for faster Omnicam deliveries.
- Given our conviction that digital technology represents the future of dentistry, we plan to continue our focus on selling and supporting technologies that improve the efficiency and clinical outcomes of dental practitioners.
- As the market for the basic infra-structure stabilizes and begins to grow, we will be there with our industry-leading offerings of chairs, units and cabinetry to assist the dentist in achieving greater efficiencies for their practices.
- Our long-term commitment to technology is exemplified by our new exclusive North American marketing agreement with Sirona, the undisputed leader in digital dental technology.
- This recently expanded agreement, which now covers Sirona's complete product line, has further strengthened Patterson Dental's position as the leading distributor of dental technology and other equipment.
- Our Dental division also completed a strategic acquisition in the second quarter with the purchase of Iowa Dental Supply.
- While not having a significant impact on reported results, the addition of the well-respected and experienced management and staff of Iowa Dental further strengthens our position in our mid-western market and provides another avenue for technology growth.
- We were very pleased with the second quarter performance of our Webster Veterinary Supply unit.
- Webster's internally-generated sales increased 13% in the second quarter.
- A change in a distribution agreement for nutritional products in the fourth quarter of fiscal 2012 reduced Webster's second quarter actual sales growth by approximately six percentage points.
- As a result, Webster reported sales of $184.4 million for the quarter.
- Webster's solidly higher second quarter sales growth was generated by strong demand for consumable supplies, including combination flea and heartworm and other parasite prevention products.
- To further strengthen its competitive position, Webster is focusing resources on its growing range of technology solutions for veterinarians and their clients, in addition to expanding local technical support capabilities for its equipment business.
- Sales of Patterson Medical, our rehabilitation supply and equipment unit, totaled $133.7 million, were virtually unchanged from the year-earlier period.
- The April 2012 acquisition of Surgical Synergies Pty Ltd., a distributor of physiotherapy, rehabilitation and mobility products serving the Australian and New Zealand markets, contributed approximately one percentage point of sales growth for this division in the second quarter.
- Patterson Medical's second quarter sales were below our internal forecast as moderately higher sales of consumable supplies in the U.S. were offset by continued weakness in the unit's international and equipment businesses.
- The softness in the unit's international and equipment businesses is likely to persist throughout the balance of fiscal 2013.
- Despite U.S. healthcare regulatory uncertainties and the weak economic environment in its global markets, we believe Patterson Medical is well-positioned to capitalize upon positive long-term demographic trends in the worldwide rehabilitation market.
- Our short-term challenge in the rehabilitation market is to deploy our resources in the most efficient manner to support our core customers as they cope with a very unsettled environment.
- Finally, as we stated in this morning's release, our second quarter sales shortfall and the outlook for continued economic uncertainty caused us to reduce our full-year earnings guidance.
- Our new range is $2.00 to $2.06 per diluted share, compared to our previously-issued guidance of $2.10 to $2.16.
- As I said at the outset, we are not satisfied with our recent results.
- While our businesses, like many others, are facing economic headwinds over the near term, we will continue to make the investments that we believe will further strengthen the competitive positions and long-term performance of our dental, veterinary and rehabilitation units.
- Finally, October 28, 2012 marked Patterson's twentieth anniversary as a publicly-traded company.

- We have experienced considerable success since 1992, growing from $277 million in annual revenue and $10 million of stockholders' equity.
- Throughout our first 20 years, we have remained focused on our future by continually strengthening our organization through the commitment and dedication of Patterson's outstanding people.
- Today, we are continuing to strengthen the competitive positions of our businesses by enhancing our value-added approach for the customer, and our confidence in Patterson's future is undiminished.
- Thank you. Now, Steve will review some additional financial highlights from our second quarter results.

R. Steven Armstrong
Chief Financial Officer

- Thank you, Scott.
- I have two additional points on our sales performance for the second quarter.
- As we disclosed in this morning's release and as Scott mentioned earlier, the change in a nutritional product arrangement in our veterinary unit reduced consolidated sales growth by 130 basis points in the quarter.
- This change, which will continue to affect our sales volumes into the first half of this year's fourth quarter, has had a minimal impact on our operating profit, since we now sell this product line under a national agency commission arrangement.
- And second, on a consolidated basis, acquisitions added 50 basis points to our second quarter sales growth, while currency exchange had essentially no impact.
- We realized sequential improvement in our consolidated gross margin from the first quarter, but two primary factors accounted for the 40 basis point decline year-over-year.
- In the Dental division, the mix of CEREC revenue shifted to a much higher proportion of sales from trade-ups to the AC, or blue cam, acquisition unit from the red cam than we saw in the same period last year or were anticipating this quarter.
- We had been planning for a higher percentage of Omnicam sales, but as Scott mentioned, the delays in the timing of shipments from the manufacturer during our quarter did not provide us sufficient product to achieve our forecasted sales of Omnicam.
- This trade-up activity not only generates a lower level of revenue per unit, but it produces a much lower gross margin than the sale of a new CEREC unit.
- However, we believe the additional volume of trade-ups from the red cam to the blue cam is further endorsement of Omnicam's market opportunity.
- The second factor affecting our consolidated gross margin was the erosion of the gross margin in the international operations of our Medical segment.
- Both channel pressures and sales mix caused this decline, particularly in European markets, which are being affected by austerity measures in Europe's healthcare systems.
- Our second quarter operating expense ratio increased as the softness in Dental and Medical sales did not allow us to gain any operating leverage.
- By segment, our second quarter operating margins were 9.2% for Dental, 13.4% for Medical and 5.0% for Veterinary.
- As I have mentioned in previous quarters, our effective tax rate has been favorably impacted by the dividends paid to the Patterson shares owned by our ESOP, and as the dividend increases, our tax rate is reduced further.
- Another factor contributing to the lower tax rate in the current and future fiscal years, involves the benefit of the domestic manufacturing deduction.
- We had previously believed that we did not qualify for a meaningful benefit under this provision of the tax code, but further study revealed that we can claim this deduction on several portions of our domestic operations.
- A review of our balance sheet shows that inventory levels increased by approximately $11 million from the start of the fiscal year.
- The growth in inventories resulted from normal seasonal fluctuations during the quarter.
- Our DSO stands at 43 days in the current period, down 2 days from the prior year, while inventory turns are 7.1 compared to 6.6 a year ago.

- We generated cash from operations of approximately $73 million in the second quarter, compared to $52 million in the year-earlier period.
- The year-over-year increase is the result of our decision to fund the prior year contribution to our Employee Stock Ownership Plan by purchasing Patterson shares in the open market in the second quarter fiscal 2012.
- At that time, we transferred $23 million to the ESOP, which then purchased 844,000 shares.
- Effectively, we converted the non-cash ESOP expense for fiscal 2012 into a cash expense, and the impact of that decision on operating cash flow occurred in last year's second quarter.
- Market conditions allowed us to fund that year's contribution for approximately $4 per share less than if we had allocated shares from the tranche acquired by the ESOP in 2006.
- The economic benefit to the shareholder of that decision was approximately $3.5 million.
- For the current fiscal year, we are planning to fund our contribution with shares from the 2006 tranche, which results in a non-cash expense as reflected in the operating cash flow.
- Our CAPEX for the first half of the year principally included regular, ongoing expenditures in contrast to last year when expenditures were incurred on the new facility for the Patterson Technology Center and the new South Bend distribution center.
- We are still anticipating fiscal 2013 CAPEX in the range of $25 to $30 million as we will be increasing investments in our information systems applications and infrastructure beginning the second half of this fiscal year.
- Also in the second quarter, we repurchased approximately 1.6 million Patterson shares under our 25 million-share buyback authorization that expires in 2016.
- Approximately 8 million shares remain available for purchase under this authorization.
- During the second quarter we retired $75 million of term debt that would have matured in March of 2013, since there was no penalty for prepayment and our cash investments were not earning at equivalent or better rates.
- With that, I'll turn it back to the conference operator, who will poll you for your questions.