MEDICIS PHARMACEUTICAL CORP
Form 10-Q
November 09, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2004

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 0-18443

MEDICIS PHARMACEUTICAL CORPORATION

(Exact name of Registrant as specified in its charter)

Delaware	52-1574808
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

8125 North Hayden Road
Scottsdale, Arizona 85258-2463

(Address of principal executive offices)
(602) 808-8800

(Registrant s telephone number, including area code)

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 x NO o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) YES x NO o

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at November 3, 2004
Class A Common Stock $.014 Par Value	54,703,427

MEDICIS PHARMACEUTICAL CORPORATION

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Part I. Financial Information

Item 1. Financial Statements

MEDICIS PHARMACEUTICAL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)

	September 30, 2004	June 30, 2004
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	$ 98,409	$ 46,621
Short-term investments	488,690	587,419
Accounts receivable, net	45,782	47,858
Inventories, net	19,622	19,540
Deferred tax assets, net	14,481	14,104
Other current assets	16,207	18,321
Total current assets	683,191	733,863
Property and equipment, net	6,248	5,842
Intangible assets:		
Intangible assets related to product line acquisitions and business combinations	312,371	312,416
Other intangible assets	15,910	15,288
	328,281	327,704
Less: accumulated amortization	56,434	51,961
Net intangible assets	271,847	275,743
Goodwill	55,400	55,401
Deferred tax assets, net	1,913	
Deferred financing costs, net	6,999	7,535
	$1,025,598	$1,078,384

See accompanying notes to condensed consolidated financial statements.

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MEDICIS PHARMACEUTICAL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)

	September 30, 2004	June 30, 2004
	(unaudited)	
Liabilities		
Current liabilities:		
Accounts payable	$ 18,523	$ 13,912
Short-term contract obligation	17,865	17,891
Income taxes payable	4,093	712
Other current liabilities	31,136	34,605
Total current liabilities	71,617	67,120
Long-term liabilities:		
Contingent convertible senior notes	453,065	453,067
Deferred tax liability, net		2,894
Stockholders Equity		
Preferred stock, $0.01 par value; shares authorized: 5,000,000; no shares issued		
Class A common stock, $0.014 par value; shares authorized: 150,000,000; issued and outstanding: 66,613,165 and 65,419,460 at September 30, 2004 and June 30, 2004, respectively	932	916
Class B common stock, $0.014 par value; shares authorized: 1,000,000; issued and outstanding: 0 and 758,032 at September 30, 2004 and June 30, 2004, respectively		10
Additional paid-in capital	528,287	517,468
Accumulated other comprehensive income	148	(1,020)
Deferred compensation	(1,083)	(1,212)
Accumulated earnings	229,394	230,049
Less: Treasury stock, 10,425,268 and 8,681,468 shares at cost at September 30, 2004 and at June 30, 2004, respectively	(256,762)	(190,908)
Total stockholders equity	500,916	555,303
	$1,025,598	$1,078,384

See accompanying notes to condensed consolidated financial statements.

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MEDICIS PHARMACEUTICAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(in thousands, except per share data)

	Three Months Ended	
	September 30, 2004	**September 30, 2003**
Net product revenues	$72,107	$ 60,830
Net contract revenues	16,711	2,465
Net revenues	88,818	63,295
Operating costs and expenses:		
Cost of product revenue	13,833	10,181
Selling, general and administrative	32,176	30,012
Research and development	36,513	3,539
Depreciation and amortization	5,032	3,425
Operating costs and expenses	87,554	47,157
Operating income	1,264	16,138
Interest income	2,520	2,596
Interest expense	(2,666)	(2,874)
Loss on early extinguishment of debt		(58,660)
Income (loss) before income tax (expense) benefit	1,118	(42,800)
Income tax (expense) benefit	(95)	15,636
Net income (loss)	$ 1,023	$(27,164)
Basic net income (loss) per share	$ 0.02	$ (0.50)

Diluted net income (loss) per share	$ 0.02	$ (0.50)
Cash dividend declared per common share	$ 0.03	$ 0.025
Basic common shares outstanding	57,228	54,595
Diluted common shares outstanding	60,268	54,595

See accompanying notes to condensed consolidated financial statements.

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MEDICIS PHARMACEUTICAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Three Months Ended	
	September 30, 2004	**September 30, 2003**
Operating Activities:		
Net income (loss)	$ 1,023	$ (27,164)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	5,568	3,998
Loss on disposal of property and equipment	37	
Loss (gain) on sale of available-for-sale investments	20	(118)
Amortization of deferred compensation	129	129
Deferred income tax benefit	(5,185)	(11,863)
Tax benefit from exercise of stock options	2,616	1,349
Provision for doubtful accounts and returns	300	
Accretion of premium on investments	1,308	1,573
Loss on early extinguishment of debt		58,660
Changes in operating assets and liabilities:		
Accounts receivable	1,776	9,856
Inventories	(81)	(6,780)
Other current assets	2,114	(4,020)
Accounts payable	4,611	6,019
Income taxes payable	3,381	(481)
Other current liabilities	(3,711)	2,593
Net cash provided by operating activities	13,906	33,751
Investing Activities:		
Purchase of property and equipment	(1,002)	(1,123)
Payment of direct merger costs	(25)	(298)
Payments for purchase of product rights	(578)	(798)
Purchase of available-for-sale investments	(297,629)	(165,480)
Sale of available-for-sale investments	380,033	96,129
Maturity of available-for-sale investments	15,655	40,375
Increase in restricted cash		(86)
Change in other assets		8

Net cash provided by (used in) investing activities	96,454	(31,273)
Financing Activities:		
Payment of deferred financing costs		(557)
Payment of dividends	(1,435)	(1,362)
Purchase of treasury stock	(65,855)	
Proceeds from the exercise of stock options	8,208	4,298
Net cash (used in) provided by financing activities	(59,082)	2,379
Effect of exchange rate on cash and cash equivalents	510	115
Net increase in cash and cash equivalents	51,788	4,972
Cash and cash equivalents at beginning of period	46,621	44,346
Cash and cash equivalents at end of period	$ 98,409	$ 49,318

See accompanying notes to condensed consolidated financial statements.

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MEDICIS PHARMACEUTICAL CORPORATION

NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2004
(unaudited)

1. NATURE OF BUSINESS

Medicis Pharmaceutical Corporation is a leading specialty pharmaceutical company focusing primarily on helping patients attain a healthy and youthful appearance and self-image through the development and marketing of products in the United States for the treatment of dermatological, aesthetic and podiatric conditions in the United States and Canada. The Company offers a broad range of products addressing various conditions including acne, fungal infections, rosacea, hyperpigmentation, photoaging, psoriasis, eczema, skin and skin-structure infections, seborrheic dermatitis and cosmesis (improvement in the texture and appearance of skin). In March 2003, Medicis expanded into the dermal aesthetic market through its acquisition of the exclusive U.S. and Canadian rights to market, distribute and commercialize the dermal restorative product lines known as RESTYLANE®, PERLANE® and RESTYLANE FINE LINES from Q-Med AB, a Swedish biotechnology/medical device company and its affiliates, collectively Q-Med. RESTYLANE® has been approved by the Food and Drug Administration (the FDA) for use in the United States. RESTYLANE®, PERLANE® and RESTYLANE FINE LINES have been approved for use in Canada. See Note 6 for further discussion. In addition to the Company s expansion into the dermal aesthetics market, Medicis had previously expanded into the pediatric market in November 2001 through its merger with Ascent Pediatrics, Inc. (Ascent). Ascent marketed products to U.S.-based pediatricians, including an oral treatment for children with asthma and other inflammatory respiratory conditions (ORAPRED®). On May 18, 2004, the Company closed an asset purchase agreement and license agreement and executed a securities purchase agreement with BioMarin Pharmaceutical Inc. (BioMarin). The asset purchase agreement involves BioMarin s purchase of assets related to ORAPRED®, including assets concerning the Ascent sales force. The license agreement granted BioMarin, among other things, the exclusive worldwide rights to ORAPRED®. The securities purchase agreement granted BioMarin the option to purchase all outstanding shares of common stock of Ascent, based on certain conditions. As a result, the Company no longer markets prednisolone-based products to U.S.-based pediatricians. See Note 5 for further discussion of the BioMarin transaction.

The condensed consolidated financial statements include the accounts of Medicis Pharmaceutical Corporation and its wholly owned subsidiaries (Medicis or the Company). The Company does not have any subsidiaries in which it does not own 100% of the outstanding stock. All of the Company s subsidiaries are included in the condensed consolidated financial statements. All significant intercompany accounts and transactions have been eliminated in consolidation.

The accompanying interim condensed consolidated financial statements of Medicis have been prepared in conformity with U.S. generally accepted accounting principles, consistent in all material respects with those applied in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2004 (fiscal 2004). The financial information is unaudited but reflects all adjustments, consisting only of normal recurring accruals, which are, in the opinion of the Company s management, necessary to a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of results for a full year. The information included in this Form 10-Q should be read in conjunction with the Company s Annual Report on Form 10-K for fiscal 2004. Certain prior period amounts have been reclassified to conform with current period presentation.

2. STOCK-BASED COMPENSATION

At September 30, 2004, the Company had five stock-based employee compensation plans. The Company accounts for those plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees and related Interpretations. Other than restricted stock, no stock-based employee compensation cost is reflected in net income, as all options granted

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under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The following table illustrates the effect on net income (loss) and earnings per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS No. 123), to stock-based employee compensation (amounts in thousands, except per share amounts):

	THREE MONTHS ENDED SEPTEMBER 30,	
	2004	**2003**
Net income (loss), as reported	$ 1,023	$(27,164)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	4,899	4,352
Pro-forma net loss	$(3,876)	$(31,516)
Earnings per share:		
Basic as reported	$ 0.02	$ (0.50)
Basic pro forma	$ (0.07)	$ (0.58)
Diluted as reported	$ 0.02	$ (0.50)
Diluted pro forma	$ (0.07)	$ (0.58)

As required, the pro forma disclosures above include options granted since April 1, 1996. Consequently, the effects of applying SFAS No. 123 for providing pro forma disclosures may not be representative of the effects on reported net income for future years until all options outstanding are included in the pro forma disclosures. For purposes of pro forma disclosures, the estimated fair value of stock-based compensation plans and other options is amortized to expense primarily over the vesting period.

On October 13, 2004, the Financial Accounting Standards Board (FASB) concluded that Statement 123R, *Share-Based Payment*, which would require all companies to measure compensation cost for share-based payments (including employee stock options) at fair value, would be effective for interim or annual periods beginning after June 15, 2005. Statement 123R will negatively impact the Company s earnings; however, the Company has not completed an analysis of all of the differences between Statement 123R and SFAS No. 123.

3. RESEARCH AND DEVELOPMENT COSTS AND ACCOUNTING FOR STRATEGIC COLLABORATIONS

All research and development costs, including payments related to products under development, and research consulting agreements, are expensed as incurred. The Company makes up-front, non-refundable payments to third parties for new technologies and for research and development work that has been completed. These up-front payments may be expensed at the time of payment depending on the nature of the payment made.

The Company s policy on accounting for costs of strategic collaborations determines the timing of the recognition of certain development costs. In addition, this policy determines whether the cost is classified as development expense or capitalized as an asset. Management is required to form judgments with respect to the commercial status of such products in determining whether development costs meet the criteria for immediate expense or capitalization.

On July 15, 2004, the Company entered into an exclusive license agreement with Q-Med to market, distribute, sell and commercialize in the United States and Canada Q-Med s product currently known as SubQ™. Q-Med will have the exclusive right to manufacture SubQ™ for Medicis. SubQ™ is

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currently not approved for use in the United States and Canada. Under terms of the agreement, Medicis Aesthetics Holdings Inc., a wholly owned subsidiary of Medicis, will license SubQ™ for approximately $80 million, due as follows: approximately $30 million upon closing of the transaction, which was recorded as a charge to research and development expense during the first quarter of fiscal 2005, along with approximately $0.7 million of professional fees related to the completion of the agreement; approximately $10 million upon completion of certain clinical milestones; approximately $20 million upon satisfaction of certain defined regulatory milestones; and approximately $20 million upon U.S. launch of SubQ™. The Company also will make additional milestone payments to Q-Med upon the achievement of certain commercial milestones.

On September 4, 2002, the Company purchased the Abbreviated New Drug Application (ANDA) for a pediatric prescription product from a third-party pharmaceutical company for $9.0 million. Under terms of the agreement, the Company may be required to make future contingent payments based on the achievement of certain milestones. The contingent payments, if the milestones are achieved, would be payable at the six (6)-, twelve (12)-, and eighteen (18)-month anniversaries of the closing of the agreement. During the quarters ended September 30, 2003 and March 31, 2004, the second and third milestones were achieved and $3.5 and $4.5 million, respectively, became payable to the third-party pharmaceutical company. The Company accounted for the initial payment and the subsequent contingent payments as an acquisition of an intangible asset and commenced amortizing the asset over 15 years beginning in the second quarter of fiscal 2003. This ANDA is included as part of the BioMarin transaction discussed in Note 5.

4. LICENSE OF PRODUCTS TO TARO PHARMACEUTICAL INDUSTRIES, INC.

On July 27, 2004, the Company entered into an exclusive license and optional purchase agreement with Taro Pharmaceutical Industries, Inc. (Taro) pursuant to which Taro will market, distribute and sell the LUSTRA® family of products and two development stage products in the United States, Canada and Puerto Rico. The LUSTRA® family of products are topical therapies prescribed for the treatment of ultraviolet-induced skin discolorations and hyperpigmentation usually associated with the use of oral contraceptives, pregnancy, hormone replacement therapy, sun damage and superficial trauma. The license agreement extends through July 1, 2007, after which Taro may purchase the product lines.

5. LICENSE OF ORAPRED® TO BIOMARIN

On May 18, 2004, the Company closed an asset purchase agreement and license agreement and executed a securities purchase agreement with BioMarin. The asset purchase agreement involves BioMarin s purchase of assets related to ORAPRED®, including assets concerning the Ascent field sales force. ORAPRED® and related pediatric intellectual property is owned by Ascent, a wholly owned subsidiary of Medicis. The license agreement granted BioMarin, among other things, the exclusive worldwide rights to ORAPRED®. The securities purchase agreement granted BioMarin the option to purchase all outstanding shares of common stock of Ascent, based on certain conditions. As part of the transaction, the name of Ascent Pediatrics, Inc. was changed to Medicis Pediatrics, Inc.

Under terms of the agreements, BioMarin will make license payments to Ascent of approximately $93 million payable over a five-year period as follows: approximately $10 million as of the date of the transaction; approximately $12.5 million per quarter for four quarters beginning in July 2004; approximately $2.5 million per quarter for the subsequent four quarters beginning in July 2005; approximately $2 million per quarter for the subsequent eight quarters beginning in July 2006; and approximately $1.75 million per quarter for the last four quarters of the five-year period beginning in July 2008. BioMarin will also make payments of $2.5 million per quarter for six quarters beginning in July 2004 for reimbursement of certain contingent payments as discussed in Note 7. The license agreement will terminate in July 2009. At that time, based on certain conditions, BioMarin will have the option to purchase all outstanding shares of Ascent for approximately $82 million. The payment will consist of $62 million in cash and $20 million in BioMarin common stock, based on the fair value of the stock at that time. The Company is responsible for the manufacture and delivery of finished goods inventory to BioMarin, and BioMarin is responsible

for paying the Company for future finished goods inventory delivered through June 30, 2005. As a result, the Company is required to recognize the first $60 million of license payments

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ratably through June 30, 2005. The Company has deferred approximately $2.7 million and $3.5 million in revenue under the agreement as of September 30, 2004, and June 30, 2004, respectively. The license payments received after June 30, 2005 and the reimbursement of contingent payments will be recognized as revenue when all four criteria of SAB 104 have been met.

As of the closing date of the transaction, BioMarin is responsible for all marketing and promotional efforts regarding the sale of ORAPRED®. As a result, Medicis no longer advertises and promotes any oral liquid prednisolone sodium phosphate solution product or any related line extension. During the term of the license agreement, Medicis will maintain ownership of the intellectual property and, consequently, will continue to amortize the related intangible assets. Payments received from BioMarin under the license agreement will be treated as contract revenue, which is included in net revenues in the condensed consolidated statements of income.

6. AQUISITION OF DERMAL AESTHETIC ENHANCEMENT PRODUCTS FROM THE Q-MED GROUP

On March 10, 2003, Medicis acquired all outstanding shares of HA North American Sales AB from Q-Med, a Swedish biotechnology/medical device company. HA North American Sales AB holds a license for the exclusive U.S. and Canadian rights to market, distribute and commercialize the dermal restorative product lines known as RESTYLANE®, PERLANE® and RESTYLANE FINE LINES. RESTYLANE® has been approved by the FDA for use in the United States. RESTYLANE®, PERLANE and RESTYLANE FINE LINES have been approved for use in Canada. Under terms of the agreements, a wholly owned subsidiary of Medicis acquired all outstanding shares of HA North American Sales AB for total consideration of approximately $160.0 million, payable upon the successful completion of certain milestones or events. Medicis paid $58.2 million upon closing of the transaction, $53.3 million in December 2003 upon FDA approval of RESTYLANE®, approximately $19.4 million in May 2004 upon certain cumulative commercial milestones being achieved and will pay approximately $29.1 million upon FDA approval of PERLANE. Payments and costs related to this acquisition are capitalized as an intangible asset and are amortized over 15 years beginning in March 2003.

7. MERGER OF ASCENT PEDIATRICS, INC.

As part of its merger with Ascent completed in November 2001, the Company may be required to make contingent purchase price payments (Contingent Payments) for each of the first five years following closing based upon reaching certain sales threshold milestones on the Ascent products for each twelve month period ended November 15, 2006, subject to certain deductions and set-offs. From time to time the Company assesses the probability and likelihood of payment in the coming respective November period based on current sales trends. There can be no assurance that such payment will ultimately be made nor is the accrual of a liability an indication of current sales levels. A total of approximately $17.9 million is included in short-term contract obligation in the Company s condensed consolidated balance sheets as of September 30, 2004, representing the first two years Contingent Payments. Pursuant to the merger agreement, payment of the contingent portion of the purchase price will be withheld pending the final outcome of the litigation discussed in Part II of this Form 10-Q.

8. SEGMENT AND PRODUCT INFORMATION

The Company operates in one significant business segment: Pharmaceuticals. The Company s current pharmaceutical franchises are divided between the Dermatological and Non-Dermatological fields. The Dermatological field represents products for the treatment of Acne and Acne-related dermatological conditions and Non-acne dermatological conditions. The Non-Dermatological field represents products for the treatment of Asthma (until May 2004, when the Company licensed ORAPRED® to BioMarin) and Urea Cycle Disorder. The Acne and Acne-related dermatological product lines include core brands DYNACIN®, PLEXION® and TRIAZ®. The Non-acne dermatological product lines include core brands LOPROX®, OMNICEF® and RESTYLANE®. The Non-Dermatological product lines include BUPHENYL® and ORAPRED®; the latter was one of the Company s core brands until it was licensed to BioMarin in May 2004. The Non-Dermatological field also includes contract revenues associated with licensing agreements.

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The Company s pharmaceutical products, with the exception of BUPHENYL®, are promoted to dermatologists, podiatrists and plastic surgeons. Such products are often prescribed by physicians outside these three specialties; including family practitioners, general practitioners, primary-care physicians and OB/GYNs, as well as hospitals, government agencies and others. All products, with the exception of BUPHENYL®, are sold primarily to wholesalers and retail chain drug stores. BUPHENYL® is primarily sold directly to hospitals and pharmacies. Prior to the Company s licensing of ORAPRED® to BioMarin in May 2004, the Company also promoted its pharmaceutical products to pediatricians.

The percentage of net revenues for each of the product categories is as follows:

	THREE MONTHS ENDED SEPTEMBER 30,	
	2004	**2003**
Acne and acne-related dermatological products	31%	35%
Non-acne dermatological products	45	46
Non-dermatological products	24	19
Total net revenues	100%	100%

9. INVENTORIES

The Company utilizes third parties to manufacture and package inventories held for sale, takes title to certain inventories once manufactured, and warehouses such goods until packaged for final distribution and sale. Inventories consist of salable products held at the Company s warehouses, as well as raw materials and components at the manufacturers facilities, and are valued at the lower of cost or market using the first-in, first-out method. The Company provides valuation reserves for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions.

Inventories at September 30, 2004 and June 30, 2004 are as follows (amounts in thousands):

	September 30, 2004	**June 30, 2004**
Raw materials	$ 8,733	$ 8,785
Finished goods	11,239	11,105
Valuation reserve	(350)	(350)
Total inventories	$19,622	$19,540

10. CONTINGENT CONVERTIBLE SENIOR NOTES

In June 2002, the Company sold $400.0 million aggregate principal amount of its 2.5% Contingent Convertible Notes Due 2032 (the Old Notes) in private transactions. As discussed below, approximately $230.8 million in principal amount of the Old Notes was exchanged for New Notes on August 14, 2004. The Old Notes bear interest at a rate of 2.5% per annum, which is payable on June 4 and December 4 of each year, beginning on December 4, 2002. The Company also agreed to pay contingent interest at a rate equal to 0.5% per annum during any six-month period, with the initial six-month period commencing June 4, 2007, if the average trading price of the Old Notes reaches certain thresholds. The Old Notes will mature on June 4, 2032.

The Company may redeem some or all of the Old Notes at any time on or after June 11, 2007, at a redemption price, payable in cash, of 100% of the principal amount of the Old Notes, plus accrued and unpaid interest, including contingent interest, if any. Holders of the Old Notes may require the Company to repurchase all or a portion of their Old Notes on June 4, 2007, 2012 and 2017; and upon a change in control, as defined in the indenture governing the Old Notes, at 100% of the principal amount of the Old Notes, plus accrued and unpaid interest to the date of the repurchase, payable in cash.

The Old Notes are convertible, at the holders option, prior to the maturity date into shares of the Company s Class A common stock in the following circumstances:

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during any quarter commencing after June 30, 2002, if the closing price of the Company s Class A common stock over a specified number of trading days during the previous quarter, including the last trading day of such quarter, is more than 110% of the conversion price of the Old Notes, or $31.96. The Old Notes are initially convertible at a conversion price of $29.05 per share, which is equal to a conversion rate of approximately 34.4234 shares per $1,000 principal amount of Old Notes, subject to adjustment;

if the Company has called the Old Notes for redemption;

during the five trading day period immediately following any nine consecutive day trading period in which the trading price of the Old Notes per $1,000 principal amount for each day of such period was less than 95% of the product of the closing sale price of the Company s Class A common stock on that day multiplied by the number of shares of the Company s Class A common stock issuable upon conversion of $1,000 principal amount of the Old Notes; or

upon the occurrence of specified corporate transactions.

The Old Notes, which are unsecured, do not contain any restrictions on the payment of dividends, the incurrence of additional indebtedness or the repurchase of the Company s securities and do not contain any financial covenants.

The Company incurred $12.6 million of fees and other origination costs related to the issuance of the Old Notes. The Company is amortizing these costs over the five-year Put period, which runs through May 2007. The Put period runs from the date the Old Notes were issued to the date the Company may redeem some or all of the Old Notes.

On August 14, 2003, the Company exchanged approximately $230.8 million in principal amount of its Old Notes for approximately $283.9 million in principal amount of its 1.5% Contingent Convertible Senior Notes Due 2033 (the New Notes). Holders of Old Notes that accepted the Company s exchange offer received $1,230 in principal amount of New Notes for each $1,000 in principal amount of Old Notes. The terms of the New Notes are similar to the terms of the Old Notes, but have a different interest rate, conversion rate and maturity date. Holders of Old Notes that chose not to exchange continue to be subject to the terms of the Old Notes.

The New Notes bear interest at a rate of 1.5% per annum, which is payable on June 4 and December 4 of each year, beginning December 4, 2003. The Company will also pay contingent interest at a rate of 0.5% per annum during any six-month period, with the initial six-month period commencing June 4, 2008, if the average trading price of the New Notes reaches certain thresholds. The New Notes mature on June 4, 2033.

The Company may redeem some or all of the New Notes at any time on or after June 11, 2008, at a redemption price, payable in cash, of 100% of the principal amount of the New Notes, plus accrued and unpaid interest, including contingent interest, if any. Holders of the New Notes may require the Company to repurchase all or a portion of their New Notes on June 4, 2008, 2013 and 2018, and upon a change in control, as defined in the indenture governing the New Notes, at 100% of the principal amount of the New Notes, plus accrued and unpaid interest to the date of the repurchase, payable in cash.

The New Notes are convertible, at the holders option, prior to the maturity date into shares of the Company s Class A common stock in the following circumstances:

during any quarter commencing after September 30, 2003, if the closing price of the Company s Class A common stock over a specified number of trading days during the previous quarter, including the last trading day of such quarter, is more than 120% of the conversion price of the New Notes, or $46.51. The Notes are initially convertible at a conversion price of $38.76 per share, which is equal to a conversion rate of approximately

25.7998 shares per $1,000 principal amount of New Notes, subject to adjustment;

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if the Company has called the New Notes for redemption;

during the five trading day period immediately following any nine consecutive day trading period in which the trading price of the New Notes per $1,000 principal amount for each day of such period was less than 95% of the product of the closing sale price of the Company s Class A common stock on that day multiplied by the number of shares of the Company s Class A common stock issuable upon conversion of $1,000 principal amount of the New Notes; or

upon the occurrence of specified corporate transactions.

The New Notes, which are unsecured, do not contain any restrictions on the incurrence of additional indebtedness or the repurchase of the Company s securities and do not contain any financial covenants. The New Notes require an adjustment to the conversion price if the cumulative aggregate of all current and prior dividend increases above $0.025 per share would result in at least a one percent (1%) increase in the conversion price. This threshold has not been reached and no adjustment to the conversion price has been made.

As a result of the exchange, the outstanding principal amounts of the Old Notes and the New Notes were $169.2 million and $283.9 million, respectively. Both the New Notes and Old Notes are reported in aggregate on the Company s condensed consolidated balance sheets. During the quarter ended September 30, 2003, the Company recognized a loss on early extinguishment of debt totaling $58.7 million, consisting of a $53.1 million premium and a $5.6 million write-off of corresponding fees incurred in connection with the issuance of the Old Notes. The Company incurred approximately $5.1 million of fees and other origination costs related to the issuance of the New Notes. The Company is amortizing these costs over the five-year Put period. The Put period runs from the date the New Notes were issued to the date the Company may redeem some or all of the New Notes (August 2008).

During the quarters ended September 30, 2004, June 30, 2004, March 31, 2004 and December 31, 2003, the Old Notes met the criteria for the right of conversion into shares of the Company s Class A common stock. This right of conversion of the Holders of Old Notes was triggered by the stock closing above $31.96 on 20 of the last 30 trading days and the last trading day of the quarters ended September 30, 2004, June 30, 2004, March 31, 2004 and September 30, 2003. The Holders of Old Notes have this conversion right only until December 31, 2004. At such time and at the end of all future quarters, the conversion rights will be reassessed in accordance with the bond indenture agreement to determine if the conversion trigger rights have been achieved. During the three months ended September 30, 2004 and March 31, 2004, outstanding principal amounts of $2,000 and $6,000 of Old Notes, respectively, were converted into shares of the Company s Class A common stock. As of November 9, 2004, no other Old Notes had been converted.

11. INCOME TAXES

Income taxes have been provided for using the liability method in accordance with Statement of Financial Accounting Standard No. 109, Accounting for Income Taxes. The provision for income taxes reflects management s estimate of the effective tax rate expected to be applicable for the full fiscal year. This estimate is re-evaluated by management each quarter based on the Company s estimated tax expense for the year.

At September 30, 2004, the Company had a federal net operating loss carryforward of approximately $69.4 million that begins expiring in varying amounts in the years 2008 through 2021 if not previously utilized. The net operating loss carryforward was acquired in connection with the Company s merger with Ascent during fiscal 2002. As a result of the merger and related ownership change for Ascent, the annual utilization of the net operating loss carryforward is limited under Internal Revenue Code Section 382. Based upon this limitation, the Company estimates that approximately $23.0 million of the $69.4 million net operating loss carryforward will be realized. Accordingly, a valuation reserve has been recorded for the remaining net operating loss carryforward that is not expected to be realized.

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At September 30, 2004, the Company had a research and experimentation credit carryforward of approximately $1.3 million that begins expiring in varying amounts in the years 2008 through 2024 if not previously utilized. All of the research and experimentation credit carryforward was acquired in connection with the Company s merger with Ascent during fiscal 2002 and is subject to the limitation under Internal Revenue Code Section 383. As a result of this limitation, the Company does not expect to realize any of the research and experimentation credits acquired from Ascent. Accordingly, a valuation reserve of $1.3 million has been established for the acquired research and experimentation credits.

As a result of the limitations described above, the Company recorded a deferred tax asset valuation allowance of $17.5 million related to the net operating loss and research and experimentation credit carryforwards acquired in the merger with Ascent. Subsequent realization of loss and credit carryforwards in excess of the amounts, which the Company estimates will be realized as of September 30, 2004 will be applied to reduce the valuation allowance and goodwill recorded in connection with the merger with Ascent.

The Company took advantage of additional tax deductions available relating to the exercise of non-qualified stock options and disqualified dispositions of incentive stock options. Accordingly, the Company recorded a $2.6 million increase to equity with a corresponding $2.6 million reduction to taxes payable for the three months ended September 30, 2004. Quarterly adjustments for the exercise of non-qualified stock options and disqualified dispositions of incentive stock options may vary as they relate to the actions of the option holder or shareholder.

12. STOCK TRANSACTIONS

On January 2, 2004, the Company announced a 2 for 1 stock split in the form of a stock dividend payable on January 23, 2004 to stockholders of record at the close of business on January 12, 2004. All share and per share data have been restated to reflect the stock split effected in the form of a stock dividend.

During September 2004, all 758,032 shares of the Company s Class B common stock were exchanged for 758,032 shares of the Company s Class A common stock. As of September 30, 2004, there were no shares of Class B common stock outstanding.

During the three months ended September 30, 2004, Medicis purchased 1,743,800 shares of its Class A common stock in the open market at an average price of $37.76 per share. These stock purchases were made in accordance with a stock repurchase program that was approved by the Company s Board of Directors in August 2004. This program provides for the repurchase of up to $150 million of Class A common stock at such times as management determines. As of September 30, 2004, the Company has repurchased a total of approximately $65.9 million of Class A common stock pursuant to this program. During the three months ended September 30, 2003, Medicis did not purchase any of its shares of Class A common stock. The timing and amount of any future repurchases will depend on market conditions and corporate considerations.

13. DIVIDENDS DECLARED ON COMMON STOCK

On September 14, 2004, the Company declared a cash dividend of $0.03 per issued and outstanding share of its Class A common stock payable on October 29, 2004 to stockholders of record at the close of business on October 1, 2004. The $1.7 million dividend was recorded as a reduction of accumulated earnings and is included in other current liabilities in the accompanying condensed consolidated balance sheets as of September 30, 2004.

14. COMPREHENSIVE INCOME

Total comprehensive income includes net income and other comprehensive income, which consists of foreign currency translation adjustments and unrealized gains and losses on available-for-sale investments. Total comprehensive income for the three months ended September 30, 2004 was $2.2 million. Total comprehensive loss for the three months ended September 30, 2003 was $27.7 million.

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15. NET INCOME (LOSS) PER SHARE

The following table sets forth the computation of basic and diluted net income (loss) per share (in thousands, except per share amounts):

	Three Months Ended September 30,	
	2004	**2003**
Net income (loss)	$ 1,023	$(27,164)
Weighted average common shares outstanding	57,228	54,595
Effect of dilutive securities:		
Stock options and restricted stock	3,040	
Weighted average common and common equivalent shares	60,268	54,595
Basic net income (loss) per share	$ 0.02	$ (0.50)
Diluted net income (loss) per share	$	