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KING PHARMACEUTICALS INC
Form 10-Q
May 14, 2001

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

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2001

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____

COMMISSION FILE NO. 0-24425

KING PHARMACEUTICALS, INC.
(Exact name of registrant as specified in its charter)

TENNESSEE
(State or other jurisdiction of
incorporation or organization)
501 FIFTH STREET, BRISTOL, TN
(Address of principal executive offices)

54-1684963
(I.R.S. Employer
Identification No.)
37620
(Zip Code)

Registrant's telephone number, including area code: (423) 989-8000

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

Number of shares outstanding of Registrant's common stock as of May 10,
2001: 171,420,917

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PART I -- FINANCIAL INFORMATION

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ITEM 1. FINANCIAL STATEMENTS

KING PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED) (IN THOUSANDS)

| | MARCH 31, 2001 | DECEMBER 31, 2000 |
|--|-------------------|----------------------|
| | ----- | ----- |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents..... | \$ 169,088 | \$ 76,395 |
| Accounts receivable, net of allowance for doubtful accounts of \$5,360 and \$5,000..... | 116,381 | 120,702 |
| Inventories..... | 80,590 | 65,089 |
| Deferred income taxes..... | 26,733 | 26,733 |
| Prepaid expenses and other current assets..... | 6,670 | 28,324 |
| | ----- | ----- |
| Total current assets..... | 399,462 | 317,243 |
| | ----- | ----- |
| Property, plant and equipment, net..... | 132,395 | 128,521 |
| Intangible assets, net..... | 780,429 | 790,324 |
| Other assets..... | 45,154 | 46,307 |
| | ----- | ----- |
| Total assets..... | \$1,357,440 | \$1,282,395 |
| | ===== | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable..... | \$ 14,959 | \$ 25,010 |
| Accrued expenses..... | 88,953 | 78,545 |
| Income taxes payable..... | 25,228 | -- |
| Current portion of long-term debt..... | 1,524 | 1,527 |
| | ----- | ----- |
| Total current liabilities..... | 130,664 | 105,082 |
| Long-term debt: | | |
| Senior subordinated notes..... | 96,382 | 96,382 |
| Other..... | 2,511 | 2,623 |
| Deferred income taxes..... | 16,989 | 16,989 |
| Other liabilities..... | 71,064 | 73,586 |
| | ----- | ----- |
| Total liabilities..... | 317,610 | 294,662 |
| | ----- | ----- |
| Commitments and contingencies (notes 4 and 5) | | |
| Shareholders' equity..... | 1,039,830 | 987,733 |
| | ----- | ----- |
| Total liabilities and shareholders' equity..... | \$1,357,440 | \$1,282,395 |
| | ===== | ===== |

See accompanying notes.

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED) (IN THOUSANDS, EXCEPT PER SHARE DATA)

| | THREE MONTHS ENDED MARCH 31, | |
|---|---------------------------------|-----------|
| | 2001 | 2000 |
| Revenues: | | |
| Net sales..... | \$169,900 | \$122,453 |
| Royalty revenue..... | 11,417 | 12,742 |
| Total revenues..... | 181,317 | 135,195 |
| Operating costs and expenses: | | |
| Cost of revenues, including royalty expense of \$2,847 and \$2,425..... | 37,416 | 30,375 |
| Selling, general and administrative..... | 32,266 | 33,198 |
| Co-promotion fees..... | 17,464 | -- |
| Co-promotion marketing expense..... | 5,529 | -- |
| Depreciation and amortization..... | 11,375 | 9,277 |
| Research and development..... | 4,015 | 3,665 |
| Merger, restructuring, and other nonrecurring charges..... | -- | 20,789 |
| Total operating costs and expenses..... | 108,065 | 97,304 |
| Operating income..... | 73,252 | 37,891 |
| Other income (expense): | | |
| Interest income..... | 2,509 | 4,021 |
| Interest expense..... | (2,867) | (14,032) |
| Other, net..... | (1,571) | (126) |
| Total other income (expense)..... | (1,929) | (10,137) |
| Income before income taxes and cumulative effect of change in accounting principle..... | 71,323 | 27,754 |
| Income tax expense..... | (26,604) | (17,958) |
| Income before cumulative effect of change in accounting principle..... | 44,719 | 9,796 |
| Cumulative effect of change in accounting principle, net of income taxes of \$325..... | (545) | -- |
| Net income..... | \$ 44,174 | \$ 9,796 |
| Income per common share: | | |
| Basic: | | |
| Income before cumulative effect of change in accounting principle..... | \$ 0.26 | \$ 0.06 |
| Cumulative effect of change in accounting principle.... | -- | -- |
| Net income..... | \$ 0.26 | \$ 0.06 |
| Diluted: | | |
| Income before cumulative effect of change in accounting principle..... | \$ 0.26 | \$ 0.06 |
| Cumulative effect of change in accounting principle.... | -- | -- |

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| | | |
|-----------------|---------|---------|
| Net income..... | \$ 0.26 | \$ 0.06 |
| | ===== | ===== |

See accompanying notes.

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KING PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY AND OTHER
COMPREHENSIVE INCOME
(UNAUDITED)
(IN THOUSANDS, EXCEPT SHARE DATA)

| | SHARES | AMOUNT | RETAINED EARNINGS | TOTAL |
|--|-------------|-----------|----------------------|-------------|
| | ----- | ----- | ----- | ----- |
| Balance at December 31, 2000..... | 170,841,178 | \$658,948 | \$328,785 | \$ 987,733 |
| Net income and total comprehensive income... | -- | -- | 44,174 | 44,174 |
| Exercise of stock options..... | 429,054 | 5,741 | -- | 5,741 |
| Effect of acceleration of vesting options from restructuring..... | -- | 2,182 | -- | 2,182 |
| | ----- | ----- | ----- | ----- |
| Balance at March 31, 2001..... | 171,270,232 | \$666,871 | \$372,959 | \$1,039,830 |
| | ===== | ===== | ===== | ===== |

See accompanying notes.

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KING PHARMACEUTICALS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(IN THOUSANDS)

| | THREE MONTHS ENDED MARCH 31, | |
|--|---------------------------------|-----------|
| | 2001 | 2000 |
| | ----- | ----- |
| Cash flows from operating activities..... | \$ 95,767 | \$ 34,068 |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Purchase of investment securities..... | -- | (9,857) |
| Proceeds from maturity and sale of investment securities..... | -- | 85,424 |
| Loans receivable..... | (5,000) | -- |
| Purchases of property, plant and equipment..... | (7,041) | (5,150) |
| Proceeds from sale of product rights..... | 3,332 | -- |
| Proceeds from sale of assets..... | 43 | 275 |

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| | | |
|---|-----------|-----------|
| Net cash (used in) provided by investing activities..... | (8,666) | 70,692 |
| Cash flows from financing activities: | | |
| Proceeds from revolving credit facility..... | -- | 9,000 |
| Payments on revolving credit facility..... | -- | (54,000) |
| Proceeds from issuance of common shares and exercise of stock options, net..... | 5,741 | 5,089 |
| Payments of cash dividends-Jones..... | -- | (1,309) |
| Payments on other long-term debt and capital lease obligations..... | (115) | (26,630) |
| Other..... | (34) | -- |
| Net cash provided by (used in) financing activities..... | 5,592 | (67,850) |
| Increase in cash and cash equivalents..... | 92,693 | 36,910 |
| Cash and cash equivalents, beginning of period..... | 76,395 | 131,723 |
| Cash and cash equivalents, end of period..... | \$169,088 | \$168,633 |

See accompanying notes.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2001 AND 2000
(IN THOUSANDS)

1. GENERAL

The accompanying unaudited interim condensed consolidated financial statements of King Pharmaceuticals, Inc. (the "Company") have been prepared by the Company in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X, and accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of items of a normal recurring nature) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2001 are not necessarily indicative of the results that may be expected for the year ending December 31, 2001. These interim statements should be read in conjunction with the financial statements and notes thereto included in the Company's latest Annual Report on Form 10-K. The year-end condensed balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles.

These consolidated financial statements include the accounts of King and its wholly owned subsidiaries, Monarch Pharmaceuticals, Inc.; Parkedale Pharmaceuticals, Inc.; King Pharmaceuticals Research and Development, Inc. (formerly Medco Research, Inc.); Jones Pharma Incorporated; and King Pharmaceuticals of Nevada, Inc. All intercompany transactions and balances have been eliminated in consolidation.

2. EARNINGS PER SHARE

The basic and diluted income per common share was determined using the

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following share data:

| | THREE MONTHS ENDED MARCH 31, | |
|--|---------------------------------|---------|
| | 2001 | 2000 |
| | ----- | ----- |
| Basic income per common share: | | |
| Weighted average common shares..... | 171,047 | 156,771 |
| | ===== | ===== |
| Diluted income per common share: | | |
| Weighted average common shares..... | 171,047 | 156,771 |
| Effect of stock options..... | 1,956 | 3,625 |
| | ----- | ----- |
| Weighted average common shares plus assumed conversions... | 173,003 | 160,396 |
| | ===== | ===== |

3. INVENTORIES

Inventories consist of the following:

| | MARCH 31, 2001 | DECEMBER 31, 2000 |
|---|-------------------|----------------------|
| | ----- | ----- |
| Finished goods (including \$9,672 and \$6,821 of sample inventory, respectively)..... | \$ 62,264 | \$ 49,825 |
| Work-in-process..... | 5,221 | 6,662 |
| Raw materials..... | 13,105 | 8,602 |
| | ----- | ----- |
| | \$ 80,590 | \$ 65,089 |
| | ===== | ===== |

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

4. MERGERS, RESTRUCTURING AND NONRECURRING CHARGES

A. Merger with Medco

On February 25, 2000, the Company completed a merger with Medco Research, Inc. ("Medco"). The Medco merger was accounted for as a pooling of interests. In connection with this transaction the Company charged to expense \$20,789 of merger related costs in the first quarter of 2000. The types of costs incurred and the actual cash payments made in the first quarter of 2001 as well as the remaining accrued balances at March 31, 2001 are summarized below:

| ACCRUED BALANCE AT DECEMBER 31, | ACCRUED BALANCE AT MARCH 31, |
|---------------------------------------|------------------------------------|
|---------------------------------------|------------------------------------|

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| | 2000 | PAYMENTS | 2001 |
|-------------------------------|---------|----------|---------|
| | ----- | ----- | ----- |
| Transaction costs..... | \$ 797 | \$17 | \$ 780 |
| Employee costs and other..... | 439 | -- | 439 |
| | ----- | --- | ----- |
| Total..... | \$1,236 | \$17 | \$1,219 |
| | ===== | === | ===== |

B. Merger with Jones

On August 31, 2000, the Company completed a merger with Jones Pharma Incorporated ("Jones"). The Jones merger was accounted for as a pooling of interests. In connection with the merger with Jones, the Company incurred total merger and restructuring related costs of \$35,317. The types of costs incurred and the actual cash payments made in the first quarter of 2001 as well as the remaining accrued balances at March 31, 2001 are summarized below:

| | ACCRUED BALANCE AT DECEMBER 31, 2000 | ACTIVITY JANUARY 1, 2001 THROUGH MARCH 31, 2001 | ACCRUED BALANCE AT MARCH 31, 2001 |
|--|---|--|--|
| | ----- | ----- | ----- |
| Transaction costs..... | \$ 620 | \$ 248 | \$ 372 |
| Employee costs, including severance and acceleration of vesting of options..... | 3,707 | 2,439 | 1,268 |
| | ----- | ----- | ----- |
| Total..... | \$4,327 | \$2,687 | \$1,640 |
| | ===== | ===== | ===== |

All activity was paid in cash except for a \$1.3 million reclassification of acceleration of vesting of options to shareholders' equity.

The following information presents certain unaudited financial data of the separate companies during the first quarter of 2000:

| | NET REVENUE | NET INCOME |
|--|----------------|---------------|
| | ----- | ----- |
| Medco (through date of acquisition)..... | \$ 9,169 | \$ 7,244 |
| Jones..... | 45,734 | 19,172 |
| | ----- | ----- |
| Total..... | \$54,903 | \$26,416 |
| | ===== | ===== |

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C. Discontinuance of Fluogen(R)

On September 27, 2000, the Company received written notification from the United States Food and Drug Administration (FDA) that it must cease manufacturing and distributing Fluogen(R), an influenza vaccine, until the Company demonstrated compliance with related FDA regulations. In addition, the notification recommended that the Company properly dispose of Fluogen(R) inventory on hand. As a result of this notification, the Company decided to permanently discontinue Fluogen(R) production and distribution. This restructuring plan resulted in the elimination of approximately 160 employees of which approximately 110 were hourly and 50 were salaried. As a result of these events, the Company recorded extraordinary losses on disposed and impaired assets of \$43.7 million, before tax benefit of \$16.4 million, and a nonrecurring charge of \$8.6 million for the year ended December 31, 2000. A summary of the types of costs incurred in the first quarter 2001 and the remaining accrued balances at March 31, 2001 are summarized below:

| | ACCRUED BALANCE AT DECEMBER 31, 2000 | PAYMENTS | OTHER(1) | ACCRUED BALANCE AT MARCH 31, 2001 |
|---|---|----------|----------|--|
| | ----- | ----- | ----- | ----- |
| Nonrecurring charges | | | | |
| Employee costs, including severance and acceleration of vesting of options..... | \$5,270 | \$4,412 | \$858 | \$ -- |
| Contractual commitments and cleanup activities..... | 1,296 | 203 | -- | 1,093 |
| | ----- | ----- | ----- | ----- |
| Total..... | \$6,566 | \$4,615 | \$858 | \$1,093 |
| | ===== | ===== | ===== | ===== |

(1) Includes reclassification of acceleration of vesting of options to shareholders' equity.

D. Discontinuance of Pallacor(TM) Research and Development Efforts

In September 2000 management decided to discontinue the research and development efforts relating to Pallacor(TM) due to the Company's inability to out-license rights to the product and its assessment of the significance of projected research and development costs relative to the likelihood of the project's success resulting in a nonrecurring research and development charge of \$6.1 million. At December 31, 2000 and March 31, 2001 the Company had \$4.7 million and \$3.1 million, respectively, accrued for all estimated remaining contractual commitments associated with Pallacor(TM).

5. CONTINGENCIES

Fen/Phen Litigation

Many distributors, marketers and manufacturers of anorexigenic drugs have been subject to claims relating to the use of these drugs. Generally, the lawsuits allege that the defendants (1) misled users of the products with respect to the dangers associated with them, (2) failed to adequately test the products and (3) knew or should have known about the negative effects of the drugs, and should have informed the public about the risks of such negative effects. The actions generally have been brought by individuals in their own

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right and have been filed in various state and federal jurisdictions throughout the United States. They seek, among other things, compensatory and punitive damages and/or court supervised medical monitoring of persons who have ingested the product. The Company is one of many defendants in more than 33 lawsuits which claim damages for personal injury arising from the Company's production of the anorexigenic drug, phentermine, under contract for GlaxoSmithKline. The Company expects to be named in additional lawsuits related to the Company's production of the anorexigenic drug under contract for GlaxoSmithKline.

While the Company cannot predict the outcome of these suits, the Company believes that the claims against it are without merit and intends to vigorously pursue all defenses available to it. The Company is being indemnified in all of these suits by GlaxoSmithKline for which it manufactured the anorexigenic product,

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

provided that neither the lawsuits nor the associated liabilities are based upon the independent negligence or intentional acts of the Company, and intends to submit a claim for all unreimbursed costs to its product liability insurance carrier. However, in the event that GlaxoSmithKline is unable to satisfy or fulfill its obligations under the indemnity, the Company would have to defend the lawsuit and be responsible for damages, if any, which are awarded against it or for amounts in excess of the Company's product liability coverage.

In addition, Jones, a wholly-owned subsidiary of the Company is a defendant in more than two thousand five hundred multi-defendant lawsuits involving the manufacture and sale of dexfenfluramine, fenfluramine and phentermine. These suits have been filed in various jurisdictions throughout the United States, and in each of these suits, Jones is one of many defendants, including manufacturers and other distributors of these drugs. Although Jones has not at any time manufactured dexfenfluramine, fenfluramine, or phentermine, Jones was a distributor of a generic phentermine product, and, after the acquisition of Abana Pharmaceuticals, was a distributor of Obenix, its branded phentermine product. The plaintiffs in these cases claim injury as a result of ingesting a combination of these weight-loss drugs and are seeking compensatory and punitive damages as well as medical care and court supervised medical monitoring. The plaintiffs claim liability based on a variety of theories including but not limited to, product liability, strict liability, negligence, breach of warranty, and misrepresentation.

Jones denies any liability incident to the distribution of Obenix or its generic phentermine product and intends to pursue all defenses available to it. Jones has tendered defense of these lawsuits to its insurance carriers for handling and they are currently defending Jones in these suits. The manufacturers of fenfluramine and dexfenfluramine have settled many of these cases. In the event that Jones' insurance coverage is inadequate to satisfy any resulting liability, Jones will have to resume defense of these lawsuits and be responsible for the damages, if any, that are awarded against it.

While the Company cannot predict the outcome of these suits, management believes that the claims against Jones are without merit and intends to vigorously pursue all defenses available.

State of Wisconsin Investment Board

On November 30, 1999, the Company entered into an agreement of merger with Medco Research, Inc. ("Medco") pursuant to which the Company acquired Medco in

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an all stock, tax-free pooling of interests transaction (Note 4), which was subject to approval by the Medco shareholders. On January 5, 2000, Medco issued to its stockholders a proxy statement with respect to the proposed transaction and noticed a meeting to approve the transaction for February 10, 2000.

On January 11, 2000, the State of Wisconsin Investment Board, ("SWIB"), a Medco shareholder which held approximately 11.6% of the outstanding stock of Medco, filed suit on behalf of a proposed class of Medco shareholders in the Court of Chancery for the State of Delaware, New Castle County, (State of Wisconsin Investment Board v. Bartlett, et al., C.A. No. 17727) against Medco and members of Medco's board of directors to enjoin the shareholder vote on the merger and the consummation of the merger. SWIB alleged, among other things, that the proxy materials filed by Medco failed to disclose all material information and included misleading statements regarding the transaction, its negotiation, and its approval by the Medco board of directors; that the Medco directors were not adequately informed and did not adequately inform themselves of all reasonably available information before recommending the transaction to Medco shareholders; and that the Medco directors were disloyal and committed waste in allegedly enabling one of the Medco directors to negotiate the transaction purportedly for his own benefit and in agreeing to terms that precluded what the complaint alleged were more beneficial alternative transactions. SWIB also moved for a preliminary injunction to enjoin the shareholder vote and the merger based on the claims asserted in its complaint. Medco and the other defendants denied all allegations and continue to deny them.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

After Medco distributed a supplemental proxy statement on January 31, 2000 and the court postponed the February 10, 2000 vote on the merger agreement for 15 days to allow shareholders sufficient time to consider the supplemental disclosures, the court rejected SWIB's claims in a February 24, 2000 Memorandum Opinion and denied preliminary injunctive relief because SWIB had not shown a reasonable likelihood of success following trial on the merits. The court made a number of preliminary findings, including that the Medco board of directors properly delegated to one of its directors the responsibility to negotiate the merger; that the payment of the negotiating fee was a proper exercise of business judgment and did not constitute waste; that the other merger provisions were also valid; that the Medco directors were adequately informed of all material information reasonably available to them prior to approving the merger agreement; that the Medco directors acted independently and in good faith to benefit the economic interests of the Medco shareholders; that the alleged omissions in the proxy statements were not material; and that the Medco board of directors fully met its duty of complete disclosure with respect to the transaction.

SWIB has filed an Application for a Scheduling Order stating its intention to dismiss the case, before a class has been certified, without prejudice. In the meantime, the action is still pending. While SWIB has indicated that it does not intend to prosecute the merits of the case further, another shareholder could intervene and continue the action. Even though SWIB lost its motion for preliminary injunction, and is going to dismiss the case, SWIB has claimed that its attorneys are entitled to an award of attorney's fees and costs. SWIB has petitioned the court for approximately \$7.26 million in attorney's fees and approximately \$270,000 in costs.

A hearing on SWIB's petition to dismiss and for attorney's fees and costs was held on June 26, 2000 in the Court of Chancery for the State of Delaware. No ruling has yet been issued.

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The Company believes that SWIB's case, including SWIB's claim for significant attorney's fees which includes fees based on a formula related to an alleged benefit conferred on Medco shareholders, is meritless, and the Company is vigorously contesting it. The Company believes SWIB's actions did not confer a benefit on the Medco shareholders. The Company also believes it is unlikely that another shareholder will intervene to continue the action, but if that results then the Company will vigorously contest it.

Other

The Parkedale Facility was one of six facilities owned by Warner-Lambert Company (predecessor in interest to Pfizer, Inc.) subject to a Consent Decree of Permanent Injunction issued August 1993 in United States of America v. Warner-Lambert Company and Melvin R. Goodes and Lodewijk J.R. DeVink (U.S. Dist. Ct., Dist. of N.J.) (the "Consent Decree"). The Parkedale Facility is currently manufacturing pharmaceutical products subject to the Consent Decree which prohibits the manufacture and delivery of specified drug products unless, among other things, the products conform to current good manufacturing practices and are produced in accordance with an approved abbreviated new drug application or new drug application. The Company intends, when appropriate, to petition for relief from the Consent Decree.

The FDA announced in an August 14, 1997 Federal Register Notice that orally administered drug products containing levothyroxine sodium are now classified as new drugs. Manufacturers who wish to continue to market these products must submit new drug applications (NDAs). After August 14, 2001, any levothyroxine sodium product marketed without an approved NDA will be subject to regulatory action. Levoxyl(R), since it was marketed prior to the date of this notice, will continue to be eligible for marketing until August 14, 2001. The Company filed for an NDA for Levoxyl(R) and is awaiting a response from the FDA.

The Company is involved in various routine legal proceedings incident to the ordinary course of its business.

KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

Summary

Management believes that the outcome of all pending legal proceedings in the aggregate will not have a material adverse affect on the Company's consolidated financial position, results of operations, or cash flows.

6. LONG-TERM DEBT

Long-term debt consists of the following:

| | MARCH 31, 2001 | DECEMBER 31, 2000 |
|--|-------------------|----------------------|
| | ----- | ----- |
| Senior subordinated notes..... | \$96,382 | \$96,382 |
| Notes payable to former owners, due in equal annual installments of principal and interest (at a rate of 6%) of \$1,226 through December 2003..... | 3,276 | 3,276 |
| Various capital leases with interest rates ranging from 8.3% | | |

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| | | |
|--|----------|----------|
| to 12.7% and maturing at various times through 2002..... | 756 | 869 |
| Other notes payable..... | 3 | 5 |
| | ----- | ----- |
| | 100,417 | 100,532 |
| Less current portion..... | 1,524 | 1,527 |
| | ----- | ----- |
| Total..... | \$98,893 | \$99,005 |
| | ===== | ===== |

As of March 31, 2001 the Company has \$100.0 million of availability under a revolving credit facility.

7. SEGMENT REPORTING

The Company's business is classified into three reportable segments: Branded Pharmaceuticals, Contract Manufacturing, and Licensed Products. Branded Pharmaceuticals include a variety of branded prescription products over four therapeutic areas: cardiovascular, anti-infective, critical care and women's health/endocrinology. Contract Manufacturing represents contract manufacturing services provided for pharmaceutical and biotechnology companies. Licensed Products represent products for which the Company has transferred the manufacturing and marketing rights to corporate partners in exchange for licensing fees and royalty payments on product sales. The classification "all other" primarily includes generic pharmaceutical products and development services.

The Company primarily evaluates its segments based on gross profit. Reportable segments were separately identified based on revenues, gross profit and total assets.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The following represents selected information for the Company's operating segments for the periods indicated:

| | THREE MONTHS ENDED MARCH 31, | |
|----------------------------------|---------------------------------|------------|
| | 2001 | 2000 |
| | ----- | ----- |
| Total revenues: | | |
| Branded pharmaceuticals..... | \$ 161,481 | \$ 113,830 |
| Licensed products..... | 11,417 | 12,742 |
| Contract manufacturing..... | 15,028 | 13,692 |
| All other..... | 524 | 339 |
| Eliminations..... | (7,133) | (5,408) |
| | ----- | ----- |
| Consolidated total revenues..... | \$ 181,317 | \$ 135,195 |
| | ===== | ===== |
| Gross profit: | | |
| Branded pharmaceuticals..... | \$ 134,368 | \$ 92,239 |
| Licensed products..... | 8,916 | 10,847 |
| Contract manufacturing..... | 579 | 1,658 |
| All other..... | 38 | 76 |

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| | | |
|--------------------------------|-------------|--------------|
| | ----- | ----- |
| Consolidated gross profit..... | \$ 143,901 | \$ 104,820 |
| | ===== | ===== |
| | AS OF | AS OF |
| | MARCH 31, | DECEMBER 31, |
| | 2001 | 2000 |
| | ----- | ----- |
| Total assets: | | |
| Branded pharmaceuticals..... | \$1,254,894 | \$1,189,997 |
| Licensed products..... | 14,723 | 10,723 |
| Contract manufacturing..... | 89,940 | 82,314 |
| All other..... | 445 | 720 |
| Eliminations..... | (2,562) | (1,359) |
| | ----- | ----- |
| Consolidated total assets..... | \$1,357,440 | \$1,282,395 |
| | ===== | ===== |

8. CO-PROMOTION AGREEMENT WITH AHP

On June 22, 2000, the Company entered into a co-promotion agreement with American Home Products Corporation ("AHP") to promote Altace(R) in the United States and Puerto Rico through October 29, 2008. Under the agreement, AHP and the Company have agreed to share various marketing expenses related to the promotion of Altace(R). The Company's share of these expenses are included in the caption "co-promotion marketing expense" in the accompanying financial statements. In addition, AHP paid an up-front fee of \$75.0 million to King which was classified as other liabilities and is being amortized over the life of the agreement. The amortization is included as a reduction of co-promotion marketing expense in the accompanying financial statements.

In connection with the co-promotion agreement with AHP, the Company has agreed to pay AHP a promotional fee as follows:

- For 2001 and 2002, 20% of net sales up to \$165.0 million, 50% of net sales from \$165.0 million to \$465.0 million and 52% of net sales in excess of \$465.0 million.
- For years subsequent to 2002 through 2008 the fee is based on the same formula, except the fee for the first \$165.0 million will be 15% of net sales.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The co-promotion fee is being accrued quarterly based on a percentage of net sales at a rate equal to the expected relationship of the expected co-promotion fee for the year to applicable expected net sales for the year.

9. CHANGE IN ACCOUNTING PRINCIPLE

In the first quarter of 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, which establishes

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accounting and reporting standards for derivative instruments and hedging activities. The cumulative effect of the change in accounting principle was \$0.5 million, net of income taxes of \$0.3 million. In addition, the change in the value of the derivatives in the quarter ended March 31, 2001 of \$1.5 million was included in other expense.

The primary derivative of the Company relates to the conversion feature in the \$20,000 convertible senior note from Novavax, Inc. The conversion feature allows the Company to convert the convertible senior note to common shares of Novavax, Inc. at a specified conversion price.

10. GUARANTOR FINANCIAL STATEMENTS

The Company's wholly-owned subsidiaries Monarch Pharmaceuticals, Inc.; King Pharmaceuticals Research and Development, Inc.; Parkedale Pharmaceuticals, Inc.; Jones Pharma Incorporated and King Pharmaceuticals of Nevada, Inc. (the "Guarantor Subsidiaries") have guaranteed the Company's performance under the \$150,000, 10 3/4% Senior Subordinated Notes due 2009 on a joint and several basis. There are no restrictions under the Company's financing arrangements on the ability of the Guarantor Subsidiaries to distribute funds to the Company in the form of cash dividends, loans or advances. The following consolidating financial data provides information regarding the financial position, results of operations and cash flows of the Guarantor Subsidiaries (condensed consolidating financial data). Separate financial statements and other disclosures concerning the Guarantor Subsidiaries are not presented because management has determined that such information would not be material to the holders of the notes.

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

GUARANTOR SUBSIDIARIES

CONDENSED CONSOLIDATING BALANCE SHEETS

| | MARCH 31, 2001 | | | DECEMBER 31, 2000 | | |
|--|----------------|---------------------------|------------------------|----------------------|-----------|----|
| | KING | GUARANTOR SUBSIDIARIES | ELIMINATING ENTRIES | KING CONSOLIDATED | KING | SU |
| ASSETS | | | | | | |
| Current assets: | | | | | | |
| Cash and cash equivalents..... | \$ 171,346 | \$ (2,258) | \$ -- | \$ 169,088 | \$ 82,316 | \$ |
| Accounts receivable, net..... | 8,591 | 110,352 | (2,562) | 116,381 | 7,027 | |
| Inventories..... | 9,282 | 71,308 | -- | 80,590 | 3,856 | |
| Deferred income taxes..... | 23,939 | 2,794 | -- | 26,733 | 23,939 | |
| Prepaid expenses and other current assets..... | 4,894 | 1,776 | -- | 6,670 | 39,637 | |
| | ----- | ----- | ----- | ----- | ----- | |
| Total current assets..... | 218,052 | 183,972 | (2,562) | 399,462 | 156,775 | |
| | ----- | ----- | ----- | ----- | ----- | |
| Property, plant, and equipment, net..... | 32,611 | 99,784 | -- | 132,395 | 28,831 | |

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| | | | | | |
|------------------------------------|-------------|------------|-------------|-------------|-------------|
| Intangible assets, net..... | 412,686 | 367,743 | -- | 780,429 | 418,895 |
| Investment in subsidiaries..... | 987,880 | -- | (987,880) | -- | 911,602 |
| Other assets..... | 22,465 | 22,689 | -- | 45,154 | 24,940 |
| | ----- | ----- | ----- | ----- | ----- |
| Total assets... | \$1,673,694 | \$ 674,188 | \$(990,442) | \$1,357,440 | \$1,541,043 |
| | ===== | ===== | ===== | ===== | ===== |

LIABILITIES AND SHAREHOLDERS' EQUITY

| | | | | | |
|---|-------------|------------|-------------|-------------|-------------|
| Current liabilities: | | | | | |
| Accounts payable..... | \$ 1,932 | \$ 15,589 | \$ (2,562) | \$ 14,959 | \$ 2,080 |
| Accrued expenses..... | 7,018 | 81,935 | -- | 88,953 | 13,048 |
| Income taxes payable..... | 9,662 | 15,566 | -- | 25,228 | -- |
| Current portion of long-term debt..... | 1,495 | 29 | -- | 1,524 | 1,498 |
| | ----- | ----- | ----- | ----- | ----- |
| Total current liabilities... | 20,107 | 113,119 | (2,562) | 130,664 | 16,626 |
| | ----- | ----- | ----- | ----- | ----- |
| Long-term debt..... | 98,887 | 6 | -- | 98,893 | 98,992 |
| Deferred income taxes..... | 14,592 | 2,397 | -- | 16,989 | 14,592 |
| Other liabilities..... | 69,192 | 1,872 | -- | 71,064 | 71,714 |
| Intercompany (receivable) payable..... | 431,086 | (431,086) | -- | -- | 351,386 |
| | ----- | ----- | ----- | ----- | ----- |
| Total liabilities... | 633,864 | (313,692) | (2,562) | 317,610 | 553,310 |
| | ----- | ----- | ----- | ----- | ----- |
| Shareholders' equity... | 1,039,830 | 987,880 | (987,880) | 1,039,830 | 987,733 |
| | ----- | ----- | ----- | ----- | ----- |
| Total liabilities and shareholders' equity..... | \$1,673,694 | \$ 674,188 | \$(990,442) | \$1,357,440 | \$1,541,043 |
| | ===== | ===== | ===== | ===== | ===== |

DECEMBER 31, 2000

| | |
|------------------------|----------------------|
| ELIMINATING ENTRIES | KING CONSOLIDATED |
| ----- | ----- |

ASSETS

| | | |
|--|---------|-----------|
| Current assets: | | |
| Cash and cash equivalents..... | \$ -- | \$ 76,395 |
| Accounts receivable, net..... | (1,359) | 120,702 |
| Inventories..... | -- | 65,089 |
| Deferred income taxes..... | -- | 26,733 |
| Prepaid expenses and other current assets..... | -- | 28,324 |
| | ----- | ----- |
| Total current | | |

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| | | |
|---|--------------|-------------|
| assets..... | (1,359) | 317,243 |
| | ----- | ----- |
| Property, plant, and equipment, net..... | -- | 128,521 |
| Intangible assets, net..... | -- | 790,324 |
| Investment in subsidiaries..... | (911,602) | -- |
| Other assets..... | -- | 46,307 |
| | ----- | ----- |
| Total assets... | \$ (912,961) | \$1,282,395 |
| | ===== | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable..... | \$ (1,359) | \$ 25,010 |
| Accrued expenses..... | -- | 78,545 |
| Income taxes payable..... | -- | -- |
| Current portion of long-term debt..... | -- | 1,527 |
| | ----- | ----- |
| Total current liabilities... | (1,359) | 105,082 |
| | ----- | ----- |
| Long-term debt..... | -- | 99,005 |
| Deferred income taxes..... | -- | 16,989 |
| Other liabilities..... | -- | 73,586 |
| Intercompany (receivable) payable..... | -- | -- |
| | ----- | ----- |
| Total liabilities... | (1,359) | 294,662 |
| | ----- | ----- |
| Shareholders' equity... | (911,602) | 987,733 |
| | ----- | ----- |
| Total liabilities and shareholders' equity..... | \$ (912,961) | \$1,282,395 |
| | ===== | ===== |

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

GUARANTOR SUBSIDIARIES

CONSOLIDATING STATEMENTS OF INCOME

THREE MONTHS ENDED MARCH 31, 2001

| KING | GUARANTOR SUBSIDIARIES | ELIMINATING ENTRIES | KING CONSOLIDATED |
|------|---------------------------|------------------------|----------------------|
|------|---------------------------|------------------------|----------------------|

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| | | | | |
|---|----------|-----------|------------|-----------|
| Revenues: | | | | |
| Net sales..... | \$ 5,307 | \$168,767 | \$ (4,174) | \$169,900 |
| Royalty revenue.... | -- | 11,417 | -- | 11,417 |
| | ----- | ----- | ----- | ----- |
| Total revenues... | 5,307 | 180,184 | (4,174) | 181,317 |
| | ----- | ----- | ----- | ----- |
| Operating costs and expenses: | | | | |
| Costs of revenues..... | 4,650 | 36,940 | (4,174) | 37,416 |
| Selling, general and administrative... | 1,513 | 53,746 | -- | 55,259 |
| Depreciation and amortization..... | 5,309 | 6,066 | -- | 11,375 |
| Research and development..... | 198 | 3,817 | -- | 4,015 |
| Merger, restructuring and other nonrecurring charges..... | -- | -- | -- | -- |
| | ----- | ----- | ----- | ----- |
| Total operating costs and expenses... | 11,670 | 100,569 | (4,174) | 108,065 |
| | ----- | ----- | ----- | ----- |
| Operating income... | (6,363) | 79,615 | -- | 73,252 |
| | ----- | ----- | ----- | ----- |
| Other income (expense): | | | | |
| Interest income.... | 2,021 | 488 | -- | 2,509 |
| Interest expense... | (3,029) | 162 | -- | (2,867) |
| Other, net..... | (1,445) | (126) | -- | (1,571) |
| Equity in earnings of subsidiaries..... | 76,278 | -- | (76,278) | -- |
| Intercompany interest (expense)..... | 2,912 | (2,912) | -- | -- |
| | ----- | ----- | ----- | ----- |
| Total other income (expense)... | 76,737 | (2,388) | (76,278) | (1,929) |
| | ----- | ----- | ----- | ----- |
| Income before income taxes and cumulative effect of change in accounting principle..... | | | | |
| | 70,374 | 77,227 | (76,278) | 71,323 |
| | ----- | ----- | ----- | ----- |
| Income tax (expense) benefit..... | | | | |
| | (25,655) | (949) | -- | (26,604) |
| | ----- | ----- | ----- | ----- |
| Income before cumulative effect of change in accounting principle..... | | | | |
| | 44,719 | 76,278 | (76,278) | 44,719 |
| | ----- | ----- | ----- | ----- |

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| | | | | |
|---|-----------|-----------|-------------|-----------|
| Cumulative effect of change in accounting principle..... | (545) | -- | -- | (545) |
| Net income... | \$ 44,174 | \$ 76,278 | \$ (76,278) | \$ 44,174 |

THREE MONTHS ENDED MARCH 31, 2000

| | KING | GUARANTOR SUBSIDIARIES | ELIMINATING ENTRIES | KING CONSOLIDATED |
|---|----------|---------------------------|------------------------|----------------------|
| Revenues: | | | | |
| Net sales..... | \$ 3,535 | \$120,292 | \$ (1,374) | \$122,453 |
| Royalty revenue.... | -- | 12,742 | -- | 12,742 |
| Total revenues... | 3,535 | 133,034 | (1,374) | 135,195 |
| Operating costs and expenses: | | | | |
| Costs of revenues..... | 3,160 | 28,589 | (1,374) | 30,375 |
| Selling, general and administrative... | 3,356 | 29,842 | -- | 33,198 |
| Depreciation and amortization..... | 5,234 | 4,043 | -- | 9,277 |
| Research and development..... | 260 | 3,405 | -- | 3,665 |
| Merger, restructuring and other nonrecurring charges..... | 6,225 | 14,564 | -- | 20,789 |
| Total operating costs and expenses... | 18,235 | 80,443 | (1,374) | 97,304 |
| Operating income... | (14,700) | 52,591 | -- | 37,891 |
| Other income (expense): | | | | |
| Interest income.... | 206 | 3,815 | -- | 4,021 |
| Interest expense... | (14,031) | (1) | -- | (14,032) |
| Other, net..... | (92) | (34) | -- | (126) |
| Equity in earnings of subsidiaries..... | 29,192 | -- | (29,192) | -- |
| Intercompany interest (expense)..... | 1,102 | (1,102) | -- | -- |
| Total other income (expense)... | 16,377 | 2,678 | (29,192) | (10,137) |

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| | | | | |
|---|----------|-----------|-------------|----------|
| Income before income taxes and cumulative effect of change in accounting principle..... | 1,677 | 55,269 | (29,192) | 27,754 |
| | ----- | ----- | ----- | ----- |
| Income tax (expense) benefit..... | 8,119 | (26,077) | -- | (17,958) |
| | ----- | ----- | ----- | ----- |
| Income before cumulative effect of change in accounting principle..... | 9,796 | 29,192 | (29,192) | 9,796 |
| Cumulative effect of change in accounting principle..... | -- | -- | -- | -- |
| | ----- | ----- | ----- | ----- |
| Net income... | \$ 9,796 | \$ 29,192 | \$ (29,192) | \$ 9,796 |
| | ===== | ===== | ===== | ===== |

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KING PHARMACEUTICALS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

GUARANTOR SUBSIDIARIES

CONSOLIDATING STATEMENTS OF CASH FLOWS

| | THREE MONTHS ENDED MARCH 31, 2001 | | | |
|--|-----------------------------------|------------------------|---------------------|-------------------|
| | KING | GUARANTOR SUBSIDIARIES | ELIMINATING ENTRIES | KING CONSOLIDATED |
| | ----- | ----- | ----- | ----- |
| Net cash flows (used in) provided by operating activities..... | \$ 5,211 | \$ 90,556 | \$ -- | \$ 95,767 |
| | ----- | ----- | ----- | ----- |
| Cash flows from investing activities: | | | | |
| Purchase of investment securities..... | -- | -- | -- | -- |
| Proceeds from maturity and sale of investment securities..... | -- | -- | -- | -- |
| Loans receivable..... | -- | (5,000) | -- | (5,000) |
| Purchases of property, plant and equipment..... | (4,246) | (2,795) | -- | (7,041) |
| Proceeds from sale of product rights..... | 3,332 | -- | -- | 3,332 |
| Proceeds from sale of assets..... | -- | 43 | -- | 43 |
| | ----- | ----- | ----- | ----- |
| Net cash (used in) provided by investing | | | | |

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| | | | | |
|---|-----------|------------|-------|-----------|
| activities..... | (914) | (7,752) | -- | (8,666) |
| | ----- | ----- | ----- | ----- |
| Cash flows from financing activities: | | | | |
| Proceeds from revolving credit facility..... | -- | -- | -- | -- |
| Payments on revolving credit facility..... | -- | -- | -- | -- |
| Proceeds from issuance of common shares and exercise of stock options, net..... | 5,741 | -- | -- | 5,741 |
| Payments of cash dividends-Jones..... | -- | -- | -- | -- |
| Payment of senior subordinated debt..... | -- | -- | -- | -- |
| Payments on other long-term debt..... | (108) | (7) | -- | (115) |
| Other..... | (34) | -- | -- | (34) |
| Intercompany..... | 79,134 | (79,134) | -- | -- |
| | ----- | ----- | ----- | ----- |
| Net cash provided by (used in) financing activities..... | 84,733 | (79,141) | -- | 5,592 |
| | ----- | ----- | ----- | ----- |
| Increase (decrease) in cash and cash equivalents..... | 89,030 | 3,663 | -- | 92,693 |
| Cash and cash equivalents, beginning of period..... | 82,316 | (5,921) | -- | 76,395 |
| | ----- | ----- | ----- | ----- |
| Cash and cash equivalents, end of period..... | \$171,346 | \$ (2,258) | \$ -- | \$169,088 |
| | ===== | ===== | ===== | ===== |

THREE MONTHS ENDED MARCH 31, 2000

| | KING | GUARANTOR SUBSIDIARIES | ELIMINATING ENTRIES | KING CONSOLIDATED |
|--|-------------|---------------------------|------------------------|----------------------|
| | ----- | ----- | ----- | ----- |
| Net cash flows (used in) provided by operating activities..... | \$ (22,455) | \$ 56,523 | \$ -- | \$ 34,068 |
| | ----- | ----- | ----- | ----- |
| Cash flows from investing activities: | | | | |
| Purchase of investment securities..... | -- | (9,857) | -- | (9,857) |
| Proceeds from maturity and sale of investment securities..... | -- | 85,424 | -- | 85,424 |
| Loans receivable..... | -- | -- | -- | -- |
| Purchases of property, plant and equipment..... | (394) | (4,756) | -- | (5,150) |
| Proceeds from sale of product rights..... | -- | -- | -- | -- |
| Proceeds from sale of assets..... | 290 | (15) | -- | 275 |
| | ----- | ----- | ----- | ----- |
| Net cash (used in) provided by investing activities..... | (104) | 70,796 | -- | 70,692 |

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| | | | | |
|---|-----------|-----------|-------|-----------|
| Cash flows from financing activities: | | | | |
| Proceeds from revolving credit facility..... | 9,000 | -- | -- | 9,000 |
| Payments on revolving credit facility..... | (54,000) | -- | -- | (54,000) |
| Proceeds from issuance of common shares and exercise of stock options, net..... | 2,911 | 2,178 | -- | 5,089 |
| Payments of cash dividends-Jones..... | -- | (1,309) | -- | (1,309) |
| Payment of senior subordinated debt..... | (26,497) | -- | -- | (26,497) |
| Payments on other long-term debt..... | (128) | (5) | -- | (133) |
| Other..... | -- | -- | -- | -- |
| Intercompany..... | 90,274 | (90,274) | -- | -- |
| Net cash provided by (used in) financing activities..... | 21,560 | (89,410) | -- | (67,850) |
| Increase (decrease) in cash and cash equivalents..... | (999) | 37,909 | -- | 36,910 |
| Cash and cash equivalents, beginning of period..... | 11,683 | 120,040 | -- | 131,723 |
| Cash and cash equivalents, end of period..... | \$ 10,684 | \$157,949 | \$ -- | \$168,633 |

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PART I -- FINANCIAL INFORMATION

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

The following discussion contains certain forward-looking statements that reflect management's current views of future events and operations. This discussion should be read in conjunction with the following: (a) "Risk Factors" and other sections of our Annual Report on Form 10-K for the year ended December 31, 2000, which are supplemented by the discussion which follows; (b) our audited consolidated financial statements which are included in our Annual Report on Form 10-K for the year ended December 31, 2000; and (c) our unaudited consolidated financial statements and related notes thereto included in this report.

OVERVIEW

General

The following summarizes net revenues by operating segment (in thousands).

FOR THE THREE MONTHS
ENDED MARCH 31,

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| | 2001 ----- | 2000 ----- |
|------------------------------|---------------|---------------|
| Branded pharmaceuticals..... | \$161,228 | \$113,830 |
| Licensed products..... | 11,417 | 12,742 |
| Contract manufacturing..... | 8,148 | 8,284 |
| Other..... | 524 | 339 |
| | ----- | ----- |
| Total..... | \$181,317 | \$135,195 |
| | ===== | ===== |

RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2001 AND 2000

Revenues

Net revenues increased \$46.1 million, or 34.1%, to \$181.3 million in 2001 from \$135.2 million in 2000, due primarily to the acquisition and growth of branded pharmaceutical products.

Net sales from branded pharmaceutical products increased \$47.4 million, or 41.6%, to \$161.2 million in 2001 from \$113.8 million in 2000. This increase was due primarily to growth in net sales of Altace(R) and Levoxyl(R) and net sales attributable to Nordette(R) and Bicillin(R) which were acquired from American Home Products in July 2000. While we expect continued growth in net sales of our branded pharmaceuticals in the future, we refer you to the "Risk Factors" that appear in our Annual Report on Form 10-K for the year ended December 31, 2000, particularly those related to Altace(R), Levoxyl(R), and Thrombin-JMI(R), that could cause results to differ.

Revenues from licensed products decreased \$1.3 million, or 10.4%, to \$11.4 million in 2001 from \$12.7 million in 2000.

Revenues from contract manufacturing and other remained relatively flat in 2001 compared to 2000.

Operating Costs and Expenses

Total operating costs and expenses increased \$10.8 million, or 11.1%, to \$108.1 million in 2001 from \$97.3 million in 2000. The increase was due primarily to an increase in cost of revenues of \$7.0 million in 2001 and \$23.0 million in co-promotion fees and marketing expense in 2001 related to the co-promotion agreement with American Home Products for the promotion of Altace(R) in the United States and Puerto Rico, offset by \$20.8 million of merger, restructuring, and other nonrecurring charges related to the Medco merger in 2000.

Cost of revenues increased \$7.0 million, or 23.2% to \$37.4 million in 2001 from \$30.4 million in 2000. The increase resulted from cost of revenues associated with the increase in net sales of branded pharmaceuti-

cal products described above. As a percentage of revenues, cost of revenues decreased to 20.6% in 2001 from 22.5% in 2000 due to an increase in sales of higher margin products.

Selling, general and administrative expenses remained relatively flat at \$32.3 million in 2001 as compared to \$33.2 million in 2000. As a percentage of

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revenues, selling, general, and administrative expenses decreased to 17.8% in 2001 from 24.6% in 2000 due to increased revenues and the classification of all Altace(R) related marketing expenses as co-promotion marketing expense rather than selling, general and administrative during the three months ended March 31, 2001.

During the three months ended March 31, 2001, the Company incurred \$17.5 million in co-promotion fees and \$5.5 million in co-promotion marketing expense pursuant to the June 2000 co-promotion agreement with American Home Products for the promotion of Altace(R) in the United States and Puerto Rico.

Depreciation and amortization expense increased \$2.1 million, or 22.6%, to \$11.4 million in 2001 from \$9.3 million in 2000. This increase was due primarily to additional amortization expense resulting from the acquisition of Nordette(R), Bicillin(R), and Wycillin(R) in July 2000.

Research and development expense increased to \$4.0 million in 2001 from \$3.7 million in 2000.

Operating Income

Operating income increased \$35.4 million, or 93.3%, to \$73.3 million in 2001 from \$37.9 million in 2000. This increase was due primarily to the increase in branded pharmaceutical sales during the three months ended March 31, 2001 as compared to the three months ended March 31, 2000 as well as \$20.8 million of merger, restructuring, and other nonrecurring charges related to the Medco merger in 2000.

Other Income (Expense)

Interest income decreased \$1.5 million from \$4.0 million in 2000 to \$2.5 million in 2001 due to lower balances of invested cash and cash equivalents during the quarter ended March 31, 2001 as compared to the quarter ended March 31, 2000.

Interest expense decreased \$11.2 million, or 79.6%, to \$2.9 million in 2001 from \$14.0 million in 2000. This decrease is due to the reduced average debt balance in 2001 resulting from the Company's prepayment of debt obligations during 2000.

Other expense increased from \$0.1 million in 2000 to \$1.6 million in 2001 due to unrealized losses of \$1.5 million incurred as a result of the implementation of Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities".

Income Tax Expense

The effective tax rate in 2000 of 64.7% was reduced to 37.3% in 2001 due primarily to nondeductible merger related costs in 2000.

Cumulative Effect of Change in Accounting Principle

The Company recognized the cumulative effect of a change in accounting principle of \$0.5 million, net of income taxes of \$0.3 million, during the three months ended March 31, 2001 due to the adoption of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS No. 138, which establishes accounting and reporting standards for derivative instruments and hedging activities.

Net Income

Due to the factors set forth above, net income increased \$34.4 million, or

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350.9%, to \$44.2 million in 2001 from \$9.8 million in 2000.

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LIQUIDITY AND CAPITAL RESOURCES

General

We believe that existing credit facilities and cash generated from operations are sufficient to finance our current operations and working capital requirements. However, in the event we make significant future acquisitions or change our capital structure, we may be required to raise funds through additional borrowings or the issuance of additional debt or equity securities.

At present, we are actively pursuing acquisitions that may require the use of substantial capital resources. There are no present agreements or commitments with respect to any such acquisition.

THREE MONTHS ENDED MARCH 31, 2001

As of March 31, 2001 we have available up to \$100.0 million under a revolving line of credit.

We generated net cash from operations of \$95.8 million for the three months ended March 31, 2001. Our net cash provided from operations was primarily the result of \$44.2 million in net income, adjusted for non-cash depreciation and amortization of \$11.4 million, a change in income taxes payable/receivable of \$45.2 million, an increase in accrued expenses of \$10.4 million, and unrealized losses on derivative instruments of \$2.4 million. Additionally, we decreased accounts receivable by \$3.9 million and prepaid expenses and other current assets by \$2.2 million. An increase in inventory of \$12.1 million, a decrease in accounts payable of \$9.8 million, and amortization of deferred revenue of \$2.3 million offset the items previously described.

Cash flows used in investing activities was \$8.7 million due to \$7.0 million of capital expenditures, and \$5.0 million of loans receivable offset by \$3.3 million received as proceeds from the sale of product rights.

Financing activities provided \$5.6 million comprised principally of \$5.7 million from the exercise of employee stock options.

Certain Indebtedness and Other Matters

As of March 31, 2001, we had \$100.4 million of long-term debt (including current portion) and we have available up to \$100.0 million under our revolving credit facility. Certain financing arrangements require us to maintain certain minimum net worth, debt to equity, cash flow and current ratio requirements. As of March 31, 2001, we were in compliance with these covenants.

Capital Expenditures

Capital expenditures, including capital lease obligations, were \$7.0 million and \$5.2 million for the three months ended March 31, 2001 and 2000, respectively. The principal capital expenditures included property and equipment purchases and building improvements.

IMPACT OF INFLATION

We have experienced only moderate raw material and labor price increases in recent years. While we have passed some price increases along to our customers, we have primarily benefited from rapid sales growth negating most inflationary

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pressures.

RECENT ACCOUNTING PRONOUNCEMENTS

In the first quarter of 2001, we adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS No. 138, which establishes accounting and reporting standards for derivative instruments and hedging activities. The cumulative effect of the change in accounting principle was \$0.5 million, net of income taxes of \$0.3 million. In addition, the change in the value of the derivatives in the quarter ended March 31, 2001 of \$1.5 million was included in other expense.

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FORWARD-LOOKING STATEMENTS

This report includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to analyses and other information which are based on forecasts of future results and estimates of amounts not yet determinable. These statements also relate to our future prospects, developments and business strategies.

These forward-looking statements are identified by their use of terms and phrases, such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "plan," "predict," "project," "will" and similar terms and phrases, including references to assumptions. These statements are contained in sections entitled "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business" in our Annual Report on Form 10-K for the year ended December 31, 2000 and in other sections of this report.

Forward-looking statements include, but are not limited to:

- the future growth potential of, and prescription trends for our branded pharmaceutical products, particularly Altace(R), Levoxyl(R) and Thrombin-JMI(R);
- expected trends with respect to particular income and expense line items;
- the development and potential commercialization of HPV vaccines and Estrasorb(TM) by Novavax and King;
- the development by King Pharmaceuticals Research and Development of Binodisine, pre-clinical programs, and product life cycle development projects;
- our continued successful execution of our growth strategies;
- anticipated developments and expansions of our business;
- increases in sales of recently acquired products or royalty payments;
- the success of existing co-promotion agreements and the development of future co-promotion agreements;
- the high cost and uncertainty of research, clinical trials and other development activities involving pharmaceutical products;
- development of product line extensions;
- the unpredictability of the duration or future findings and

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- determinations of the FDA and other regulatory agencies worldwide;
- debt service and leverage requirements;
- the products which we expect to offer;
- the intent to market and distribute certain of our products internationally;
- the intent to manufacture certain products in our own facilities which are currently manufactured for us by third parties;
- the intent, belief or current expectations, primarily with respect to our future operating performance;
- expectations regarding sales growth, gross margins, manufacturing productivity, capital expenditures and effective tax rates; and
- expectations regarding our financial condition and liquidity as well as future cash flows and earnings.

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These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from those contemplated by our forward-looking statements. These other factors include, but are not limited to, the following:

- changes in general economic and business conditions;
- dependence on continued acquisition of products;
- management of growth of business and integration of product acquisitions;
- changes in current pricing levels;
- development of new competitive products;
- changes in economic conditions and federal and state regulations;
- competition for acquisition of products;
- manufacturing capacity constraints; and
- the availability, terms and deployment of capital.

We do not undertake to publicly update or revise any of our forward-looking statements even if experience or future changes show that the indicated results or events will not be realized.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Certain of our financial instruments are subject to market risks, including interest rate risk. Our financial instruments are not currently subject to foreign currency risk or commodity price risk. We have no financial instruments held for trading purposes.

As of March 31, 2001, there were no significant changes in our qualitative or quantitative market risk since the prior reporting period.

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PART II -- OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information required by this Item is incorporated by reference to Note 5 to the Condensed Consolidated Financial Statements included elsewhere in this document.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None

(b) Reports on Form 8-K

We filed the following Current Reports on Form 8-K during the quarter ended March 31, 2001:

(1) A Current Report on Form 8-K filed February 28, 2001 furnished under Item 9 additional quarterly financial information (Condensed Consolidated Statement of Operations for the quarters ended March 31, June 30, September 30 and December 31, 1999 and 2000 and the years ended December 31, 1999 and 2000) as a result of the mergers of King and Medco Research, Inc. on February 25, 2000 and King and Jones Pharma Incorporated on August 31, 2000, both accounted for under the pooling of interest method, as well as the restated amounts in the first three quarters of 2000 resulting from the adoption of Staff Accounting Bulletin 101 in the fourth quarter of 2000.

(2) A Current Report on Form 8-K filed January 8, 2001, reported under Item 5 the following transactions with Novavax, Inc. which were effective January 8, 2001:

- (a) King obtained an exclusive license from Novavax, Inc. to promote, market, distribute and sell Estrasorb(TM), worldwide except in the United States, Canada, Italy, the Netherlands, Greece, Switzerland and Spain. King and Novavax will co-market Estrasorb(TM) in the United States and Puerto Rico.
- (b) King divested to Novavax its rights to AVC(TM) in the United States and Puerto Rico.
- (c) King entered into a Co-promotion Agreement with Novavax to market jointly King's product Nordette(R) in the United States and Puerto Rico.

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.

KING PHARMACEUTICALS, INC.

Date: May 14, 2001

By: /s/ JOHN M. GREGORY

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John M. Gregory
Chairman and Chief Executive Officer

Date: May 14, 2001

By: /s/ JAMES R. LATTANZI

James R. Lattanzi
Chief Financial Officer

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