COVANCE INC
Form 10-Q
July 26, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 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 June 30, 2002

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 Number: 1-12213

COVANCE INC.

(Exact name of Registrant as specified in its Charter)

| Delaware | 22-3265977 |
|---|---|
| (State of Incorporation) | (I.R.S. Employer Identification No.) |
| 210 Carnegie Center, Princeton, New Jersey | 08540 |
| (Address of Principal Executive Offices) | (Zip Code) |

Registrant's telephone number, including area code: (609) 452-4440

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 [ ]

APPLICABLE ONLY TO CORPORATE ISSUERS:

As of July 18, 2002, the Registrant had 60,404,523 shares of Common Stock outstanding.

Covance Inc.
Form 10-Q For the Quarterly Period Ended June 30, 2002

INDEX

Page

COVANCE INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

| (Dollars in thousands) | June 30, 2002 (UNAUDITED) | December 31, 2001 |
|---|---|---|
| Assets | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 51,695 | $ 35,404 |
| Accounts receivable | 163,382 | 167,840 |
| Unbilled services | 47,551 | 40,895 |
| Inventory | 36,070 | 36,131 |
| Deferred income taxes | 10,689 | 13,445 |
| Prepaid expenses and other current assets | 32,301 | 30,778 |
| Total Current Assets | 341,688 | 324,493 |
| Property and equipment, net | 229,880 | 228,092 |
| Goodwill, net | 54,107 | 54,038 |
| Other assets | 5,058 | 5,405 |
| Total Assets | $ 630,733 | $ 612,028 |

| | | |
|---|---|---|
| Liabilities and Stockholders' Equity | | |
| Current Liabilities: | | |
| Accounts payable | $ 21,113 | $ 21,134 |
| Accrued payroll and benefits | 46,621 | 45,902 |
| Accrued expenses and other current liabilities | 42,127 | 40,296 |
| Unearned revenue | 101,853 | 116,712 |
| Income taxes payable | 10,503 | 2,739 |
| Total Current Liabilities | 222,217 | 226,783 |
| Long-term debt | -- | 15,000 |
| Deferred income taxes | 11,233 | 11,613 |
| Other liabilities | 14,638 | 13,687 |
| Total Liabilities | 248,088 | 267,083 |
| Commitments and Contingent Liabilities | | |
| Stockholders' Equity: | | |
| Preferred Stock - Par value $1.00 per share; 10,000,000 shares authorized; no shares issued and outstanding at June 30, 2002 and December 31, 2001, respectively | -- | -- |
| Common Stock - Par value $0.01 per share; 140,000,000 shares authorized 62,403,045 and 61,882,084 shares issued and outstanding, including those held in treasury, at June 30, 2002 and December 31, 2001, respectively | 624 | 619 |
| Paid-in capital | 130,668 | 122,217 |
| Retained earnings | 280,206 | 255,326 |
| Accumulated other comprehensive income (loss)-- Cumulative translation adjustment | (7,781) | (12,310) |
| Treasury stock at cost (2,080,449 and 2,073,772 shares at June 30, 2002 and December 31, 2001, respectively) | (21,072) | (20,907) |
| Total Stockholders' Equity | 382,645 | 344,945 |
| Total Liabilities and Stockholders' Equity | $ 630,733 | $ 612,028 |

The accompanying notes are an integral part of these consolidated financial statements.



COVANCE INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

| | Three Months Ended June 30 | | S |
|---|---|---|---|
| (Dollars in thousands, except per share data) | 2002 | 2001 | 200 |
| Net revenues | $ 219,206 | $ 226,421 | $ 42 |
| Reimbursable out-of-pockets | 10,623 | 10,279 | 2 |
| Total revenues | 229,829 | 236,700 | 44 |

| | | | |
|---|---|---|---|
| Cost and expenses: | | | |
| Cost of revenue (including reimbursable expenses) .. | 162,920 | 175,775 | 32 |
| Selling, general and administrative ..... | 34,215 | 33,171 | 6 |
| Depreciation and amortization ..... | 10,205 | 12,577 | 2 |
| Restructuring charge ..... | -- | 8,178 | |
| Total ..... | 207,340 | 229,701 | 40 |
| Income from operations ..... | 22,489 | 6,999 | 4 |
| Other (income) expense, net: | | | |
| Interest expense ..... | 483 | 2,563 | |
| Interest income ..... | (316) | (279) | |
| Foreign exchange transaction losses, net ..... | 1,522 | 159 | |
| Loss (gain) on sale of businesses ..... | -- | 8,430 | |
| Other (income) expense, net ..... | 1,689 | 10,873 | |
| Income (loss) before taxes ..... | 20,800 | (3,874) | 3 |
| Provision (benefit) for income taxes ..... | 7,698 | (1,115) | 1 |
| Net income (loss) ..... | $ 13,102 | $ (2,759) | $ 2 |
| Basic earnings (loss) per share ..... | $ 0.22 | $ (0.05) | $ |
| Weighted average shares outstanding - basic ..... | 60,527,636 | 58,534,186 | 60,40 |
| Diluted earnings (loss) per share ..... | $ 0.21 | $ (0.05) | $ |
| Weighted average shares outstanding - diluted ..... | 61,940,577 | 60,454,375 | 61,82 |

The accompanying notes are an integral part of these consolidated financial state

COVANCE INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE SIX MONTHS ENDED JUNE 30, 2002 AND 2001
(UNAUDITED)

| | Six Months Ended June 30 | |
|---|---|---|
| (Dollars in thousands) | 2002 | 2001 |
| Cash flows from operating activities: | | |
| Net income ..... | $ 24,880 | $ 29,066 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization ..... | 20,311 | 26,196 |
| Stock issued under employee benefit and stock | | |

| | | |
|---|---|---|
| compensation plans | 5,074 | 6,139 |
| Deferred income tax benefit | 2,376 | (1,369) |
| Gain on sale of businesses | -- | (30,803) |
| Restructuring charge, net of cash paid | -- | 8,178 |
| Other | 371 | 993 |
| Changes in operating assets and liabilities, net of businessses sold: | | |
| Accounts receivable | 4,458 | (4,619) |
| Unbilled services | (6,656) | 615 |
| Inventory | 61 | (1,816) |
| Accounts payable | (21) | (5,887) |
| Accrued liabilities | 2,550 | (16,959) |
| Unearned revenue | (14,859) | 5,645 |
| Income taxes payable | 7,764 | 3,644 |
| Other assets and liabilities, net | 1,044 | (15,273) |
| Net cash provided by operating activities | 47,353 | 3,750 |
| Cash flows from investing activities: | | |
| Capital expenditures | (19,273) | (27,886) |
| Proceeds from sale of businesses | -- | 251,059 |
| Other, net | (6) | 101 |
| Net cash (used in) provided by investing activities | (19,279) | 223,274 |
| Cash flows from financing activities: | | |
| Net repayments under revolving credit facilities | (15,000) | (199,000) |
| Repayments of debt | -- | (18,723) |
| Stock issued under employee stock purchase and option plans | 3,382 | 5,870 |
| Purchase of treasury stock | (165) | (146) |
| Net cash used in financing activities | (11,783) | (211,999) |
| Net change in cash and cash equivalents | 16,291 | 15,025 |
| Cash and cash equivalents, beginning of period | 35,404 | 7,191 |
| Cash and cash equivalents, end of period | $ 51,695 | $ 22,216 |

The accompanying notes are an integral part of these consolidated financial statements.



COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)
June 30, 2002 and 2001
(dollars in thousands, unless otherwise indicated)

1. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting

of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. The balance sheet at December 31, 2001 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. You should read these consolidated financial statements together with the historical consolidated financial statements of Covance Inc. and subsidiaries ("Covance") for the years ended December 31, 2001, 2000, and 1999 included in our Annual Report on Form 10-K for the year ended December 31, 2001.

2. Summary of Significant Accounting Policies

Use of Estimates

These unaudited consolidated financial statements have been prepared in conformity with GAAP, which requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Reclassifications

Certain prior period balances have been reclassified to conform with current year presentation.

Prepaid Expenses and Other Current Assets

In connection with the management of multi-site clinical trials, Covance pays on behalf of its customers fees to investigators, volunteers and other out-of-pocket costs (such as travel, printing, meetings, couriers, etc.), for which we are reimbursed at cost, without mark-up or profit. Amounts receivable from customers in connection with billed and unbilled investigator fees, volunteer payments and other out-of-pocket pass-through costs are included in prepaid expenses and other current assets in the accompanying Consolidated Balance Sheets and totaled $15.4 million and $17.2 million at June 30, 2002 and December 31, 2001, respectively. See Note 2 "Reimbursable Out-of-Pocket Expenses".

Inventory

Inventories, which consist principally of supplies, are valued at the lower of cost (first-in, first-out method) or market.

Goodwill

Effective January 1, 2002, in accordance with the adoption of Financial Accounting Standards Board ("FASB") Statement No. 142, Goodwill and Other Intangible Assets, Covance ceased amortization of goodwill. Had amortization expense not been recorded for the three months ended June 30, 2001, the impact on income from operations, net income and earnings per share would have been an increase of $0.9 million, $0.7 million, and $0.01 per share, respectively. Had amortization expense not been recorded for the six months ended June 30, 2001, the impact on income from operations, net income and earnings per share would have been an increase of $1.8 million, $1.4 million, and $0.02 per share, respectively. See Note 7 "2001 Pro Forma Financial Information".

(UNAUDITED)
June 30, 2002 and 2001
(dollars in thousands, unless otherwise indicated)

Comprehensive Income

Comprehensive income has been calculated in accordance with FASB Statement No. 130, Reporting Comprehensive Income. Covance has determined total comprehensive income (loss) to be $19.1 million and $(5.4) million for the three months ended June 30, 2002 and 2001, respectively, and $29.4 million and $26.9 million for the six months ended June 30, 2002 and 2001, respectively. Covance's total comprehensive income represents net income plus the change in the cumulative translation adjustment equity account for the periods presented.

Earnings Per Share

Earnings per share has been calculated in accordance with FASB Statement No. 128, Earnings Per Share. In computing diluted earnings per share for the three months ended June 30, 2002 and 2001, the denominator was increased by 1,412,941 shares and 1,920,189 shares, respectively, and for the six months ended June 30, 2002 and 2001, the denominator was increased by 1,422,945 shares and 1,422,243 shares, respectively, representing the dilutive effect of stock options outstanding at June 30, 2002 and 2001 with exercise prices less than the average market price of Covance's Common Stock during each respective period.

Reimbursable Out-of-Pocket Expenses

As discussed in Note 2 "Prepaid Expenses and Other Current Assets", Covance pays on behalf of its customers fees to investigators, volunteers and other out-of-pocket costs for which we are reimbursed at cost, without mark-up or profit. Effective January 1, 2002, in connection with the required implementation of Financial Accounting Standards Board Emerging Issues Task Force Rule No. 01-14 ("EITF 01-14"), Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred, amounts paid to volunteers and other out-of-pocket costs are now included in cost of revenue, while the reimbursements received are reported as revenues in the Consolidated Statements of Income. Covance will continue to exclude from revenue and expense in the Consolidated Statements of Income fees paid to investigators and the associated reimbursement since Covance acts as an agent on behalf of the pharmaceutical company sponsors with regard to investigator payments. See Note 2 "Recently Issued Accounting Standards" for additional information regarding EITF 01-14.

Segment Reporting

Covance reports information about its operating segments and related disclosures about products, services, geographic areas and major customers in accordance with FASB Statement No. 131, Disclosures About Segments of an Enterprise and Related Information. See Note 6 "Segment Information."

Recently Issued Accounting Standards

In November 2001, the FASB issued EITF 01-14, Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred. This rule requires that in cases where the contractor acts as a principal, reimbursements received for out-of-pocket expenses incurred be characterized as revenue and the associated costs be included as operating expenses in the income statement. Covance implemented this rule beginning with the quarter ended March 31, 2002 and as required, has also reclassified comparative financial information for the three and six months ended June 30, 2001. The implementation of this rule resulted only in the gross up of revenues

and expenses and has no impact upon earnings.

In October 2001, the FASB issued Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement was effective beginning with Covance's quarter ended March 31, 2002. These new rules on asset impairment supersede FASB Statement 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of and portions of APB Opinion 30, Reporting the Results of Operations. This Standard provides a single accounting model for long-lived assets to be disposed and significantly changes the criteria that would have to be met to classify an asset as held-for-sale. Classification as held-for-sale is an important distinction since such assets are not depreciated and are stated at the lower of fair value or carrying amount. This statement also requires expected future operating losses from





discontinued operations to be displayed in the period(s) in which the losses are incurred, rather than as of the measurement date as presently required. The adoption of this statement did not have a material impact on Covance's results of operations, financial position or cash flows.

In July 2001, the FASB issued Statement No. 142, Goodwill and Other Intangible Assets. This statement requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. Covance adopted this statement on January 1, 2002 and accordingly ceased the amortization of goodwill. The adoption of this statement did not have a material impact on Covance's financial position or cash flows, and the impact on diluted earnings per share was $0.01 and $0.02 per share for the three and six months ended June 30, 2002, respectively.

3. Supplemental Cash Flow Information

Cash paid for interest for the six months ended June 30, 2002 and 2001 totaled $0.8 million and $7.9 million, respectively. Cash paid for income taxes for the six months ended June 30, 2002 and 2001 totaled $9.2 million and $14.9 million, respectively.

4. Divestitures

On June 15, 2001, Covance sold its biomanufacturing business ("Biomanufacturing") to Akzo Nobel's pharma business unit, Diosynth, for gross proceeds of $113.6 million, subject to post-closing adjustments, including finalization of the closing balance sheet and earnout provision, in accordance with the Stock Purchase Agreement between Covance and Akzo Nobel, which remains to be resolved between the parties. Covance recognized a loss of $7.5 million ($4.5 million after tax) from this transaction. Covance used the net proceeds from the sale of approximately $95 million to reduce borrowings under its senior revolving credit facility.

On February 14, 2001, Covance sold its pharmaceutical packaging business ("Packaging") to Fisher Scientific International Inc. for gross proceeds of $137.5 million. Covance recognized a pre-tax gain of $38.4 million ($24.3 million after tax) from this transaction, of which $39.2 million was recorded during the three months ended March 31, 2001 in connection with the

(dollars in thousands, unless otherwise indicated)

sale, and $(0.9) million was recorded during the three months ended June 30, 2001 in connection with a final working capital adjustment. Covance used the net proceeds from the sale to repay the $18.5 million balance outstanding on the mortgage on its North American packaging facility and the remaining net proceeds of approximately $95 million were used to reduce borrowings under its senior revolving credit facility.

5. Restructuring

In June 2001, Covance announced plans to reorganize its Nexigent subsidiary, integrating Nexigent's newly developed clinical trials service offerings into Covance's core businesses and reducing Nexigent's infrastructure. Under the plan, Nexigent's service offerings - site activation, study feasibility, electronic data capture, and web-based central laboratory data access - were to continue to be marketed by Covance's core business units. Covance recorded a pre-tax restructuring charge in the second quarter of 2001, totaling approximately $8.2 million ($5.0 million net of tax). The charge consisted of approximately $6.5 million in asset write-offs, which were taken in June 2001, and approximately $1.6 million in severance and related benefits in connection with the elimination of approximately 30 redundant Nexigent positions. Severance payments began in August 2001 and will continue through 2002.





6. Segment Information

Covance has two reportable segments: early development and late-stage development. Early development services, which includes Covance's preclinical and Phase I clinical service capabilities, involve evaluating a new compound for safety and early effectiveness as well as evaluating the absorption, distribution, metabolism and excretion of the compound in the human body. It is at this stage that a pharmaceutical company, based on available data, will generally decide whether to continue further development of a drug. Late-stage development services, which include Covance's central laboratory, clinical development, biomanufacturing (through June 15, 2001), commercialization and other clinical support capabilities (including our Packaging operations through February 14, 2001), are geared toward demonstrating the clinical effectiveness of a compound in treating certain diseases or conditions, obtaining regulatory approval and maximizing the drug's commercial potential.

The information provided below for 2001 is on an "as reported" basis and has not been restated to exclude the results of Biomanufacturing and Packaging, which were divested during 2001. Certain of the information below has been presented on a pro forma basis in Note 7.

The accounting policies of the reportable segments are the same as those described in Note 2. Segment net revenues, operating income and total assets for the three and six months ended June 30, 2002 and 2001 are as follows:

| | Early Development | Late-Stage Development | Other Reconciling Items |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Three months ended June 30, 2002 | | | |
| Total revenues from external customers ... | $ 91,382 | $127,824 | $ 10,623 (a) |
| Operating income ..... | $ 16,919 | $ 16,579 | $(11,009)(c) |
| Total assets ..... | $298,429 | $320,504 | $ 11,800 (d) |
| Three months ended June 30, 2001 | | | |
| Total revenues from external customers ... | $ 78,727 | $147,694 | $ 10,279 (a) |
| Operating income ..... | $ 11,124 (b) | $ 2,899 (b) | $ (7,024)(c) |
| Total assets ..... | $239,716 | $283,815 | $ 45,645 (d) |
| Six months ended June 30, 2002 | | | |
| Total revenues from external customers ... | $176,766 | $251,022 | $ 20,323 (a) |
| Operating income ..... | $ 31,099 | $ 30,607 | $(20,065)(c) |
| Total assets ..... | $298,429 | $320,504 | $ 11,800 (d) |
| Six months ended June 30, 2001 | | | |
| Total revenues from external customers ... | $152,772 | $302,307 | $ 20,226 (a) |
| Operating income ..... | $ 22,460 (b) | $ 13,558 (b) | $(12,793)(c) |
| Total assets ..... | $239,716 | $283,815 | $ 45,645 (d) |

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(a) Represents revenues associated with reimbursable out-of-pocket expenses.
(b) Includes restructuring charge incurred in the second quarter of 2001 totaling $8,178 ($4,985 after tax).
(c) Represents corporate administrative expenses (primarily information technology, marketing, communications, human resources, finance and legal).
(d) Represents corporate assets.



COVANCE INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)
(UNAUDITED)
June 30, 2002 and 2001
(dollars in thousands, unless otherwise indicated)

7. 2001 Pro Forma Financial Information

The following is a reconciliation between amounts on an "as reported" basis and amounts on a pro forma basis for the three and six months ended June 30, 2001. The pro forma results reflect (1) the exclusion of the results of Packaging and Biomanufacturing, (2) reduced interest expense from the application of the net proceeds from the sales of these businesses to outstanding debt, (3) the exclusion of the gain (loss) recognized on the sale of businesses during the period, (4) the exclusion of restructuring charges during the period and (5) the exclusion of goodwill amortization in accordance with the adoption of FASB Statement No. 142.

| | Pro Forma Adjustments to Remove | | | | |
|---|---|---|---|---|---|
| As Reported | Packaging | Biomanu-facturing | Net Loss on Sale | Restructuring | A |

| Three Months Ended June 30, 2001 | | | | | | |
|---|---|---|---|---|---|---|
| Net revenues ..... | $ 226,421 | n/a | $ (22,563) | $ -- | $ -- | $ |
| Income from operations ..... | $ 6,999 | n/a | $ (228) | $ -- | $ 8,178 | $ |
| Income (loss) before taxes .. | $ (3,874) | n/a | $ 1,268 | $ 8,430 | $ 8,178 | $ |
| Taxes on income ..... | $ (1,115) | n/a | $ 473 | $ 3,020 | $ 3,193 | $ |
| Net income ..... | $ (2,759) | n/a | $ 795 | $ 5,410 | $ 4,985 | $ |
| Diluted earnings per share .. | $ (0.05) | n/a | $ 0.01 | $ 0.09 | $ 0.08 | $ |

| | | Pro Forma Adjustments to Remove | | | | |
|---|---|---|---|---|---|---|
| | As Reported | Packaging | Biomanu-facturing | Net Gain on Sale | Restructuring | A |
| Six Months Ended June 30, 2001 | | | | | | |
| Net revenues..... | $ 455,079 | $ (11,439) | $ (44,173) | $ -- | $ -- | $ |
| Income from operations..... | $ 23,225 | $ (3,806) | $ 1,489 | $ -- | $ 8,178 | $ |
| Income (loss) before taxes... | $ 47,376 | $ (2,579) | $ 4,970 | $ (30,803) | $ 8,178 | $ |
| Taxes on income..... | $ 18,310 | $ (762) | $ 1,954 | $ (11,888) | $ 3,193 | $ |
| Net income..... | $ 29,066 | $ (1,817) | $ 3,016 | $ (18,915) | $ 4,985 | $ |
| Diluted earnings per share... | $ 0.49 | $ (0.03) | $ 0.05 | $ (0.32) | $ 0.08 | $ |

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

You should read the following discussion together with the unaudited Covance consolidated financial statements and the accompanying notes included in this Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.

Overview

Covance is a leading contract research organization providing a wide range of product development services on a worldwide basis primarily to the pharmaceutical, biotechnology and medical device industries. Covance also provides services such as laboratory testing to the chemical, agrochemical and food industries. The foregoing services comprise two segments for financial reporting purposes: early development services, which includes preclinical and Phase I clinical; and late-stage development services, which includes central laboratory, clinical development, biomanufacturing (through June 15, 2001), commercialization and other clinical support services (including our packaging

operations through February 14, 2001). Covance believes it is one of the largest biopharmaceutical contract research organizations, based on 2001 annual net revenues, and one of a few that is capable of providing comprehensive global product development services. Covance offers its clients high quality services designed to reduce product development time. This enables Covance's customers to introduce their products into the marketplace faster and as a result, maximize the period of market exclusivity and monetary return on their research and development investments. Additionally, Covance's comprehensive services and broad experience provide its customers with a variable cost alternative to fixed cost internal development capabilities.

On June 15, 2001, Covance sold its biomanufacturing business ("Biomanufacturing") to Akzo Nobel's pharma business unit, Diosynth, for gross proceeds of $113.6 million, subject to post-closing adjustments, including finalization of the closing balance sheet and earnout provision, in accordance with the Stock Purchase Agreement between Covance and Akzo Nobel, which remains to be resolved between the parties. Covance recognized a loss of $7.5 million ($4.5 million after tax) from this transaction. On February 14, 2001, Covance sold its pharmaceutical packaging business ("Packaging") to Fisher Scientific International Inc. for gross proceeds of $137.5 million. Covance recognized a pre-tax gain of $38.4 million ($24.3 million after tax) from this transaction, of which $39.2 million was recorded during the three months ended March 31, 2001 in connection with the sale, and $(0.9) million was recorded during the three months ended June 30, 2001 in connection with a final working capital adjustment.

Historically, a majority of Covance's net revenues have been earned under contracts. These contracts generally range in duration from a few months to two years, but can extend in duration up to five years. Revenue from these contracts is generally recognized under either the percentage of completion method of accounting or as services are rendered or products are delivered, depending upon the nature of the work contracted. Where the percentage of completion method is used, Covance generally measures progress toward completion in terms of units-of-work performed as compared to the total units-of-work contracted. The contracts may contain provisions for renegotiation for cost overruns arising from changes in the scope of work. Renegotiated amounts are included in net revenues when earned and realization is assured. In some cases, for multi-year contracts a portion of the contract fee is paid at the time the trial is initiated. These amounts are deferred and recognized as revenue as services are performed. Additional payments are made based upon the achievement of performance-based milestones over the contract duration. In connection with the management of multi-site clinical trials, Covance pays on behalf of its customers fees to investigators, volunteers and other out-of-pocket costs (such as travel, printing, meetings, couriers, etc.), for which we are reimbursed at cost, without mark-up or profit. Investigator fees are not reflected in total revenues or expenses since Covance acts in the capacity of an agent on behalf of the pharmaceutical company sponsor, passing through these costs without risk or reward to Covance. Most contracts are terminable either immediately or upon notice by the client. These contracts typically require payment to Covance of expenses to wind down a study, payment to Covance of fees earned to date, and, in some cases, a termination fee or a payment to Covance of some portion of the fees or profit that could have been earned by Covance under the contract if it had not been terminated early.

Effective January 1, 2002, in connection with the required implementation of Financial Accounting Standards Board Emerging Issues Task Force Rule No. 01-14 ("EITF 01-14"), Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred, amounts paid to volunteers and other out-of-pocket costs are now included in cost of revenue, while the reimbursements received are reported as reimbursable out-of-pocket revenues in the Consolidated Statements of Income. Covance will continue to exclude from revenue and expense in the Consolidated Statements of Income fees

paid to investigators and the associated reimbursement since Covance acts as an agent on behalf of the pharmaceutical company sponsors with regard to investigator payments. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - New Accounting Pronouncements" for additional information regarding EITF 01-14.



Covance segregates its recurring operating expenses among three categories: cost of revenue; selling, general and administrative expenses; and depreciation and amortization. Cost of revenue consists of appropriate amounts necessary to complete the revenue and earnings process, and includes direct labor and related benefit charges, other direct costs and an allocation of facility charges and information technology costs and excludes depreciation and amortization. Also, as mentioned above, cost of revenue now includes reimbursable out-of-pocket costs. Cost of revenue, as a percentage of net revenues, tends and is expected to fluctuate from one period to another, as a result of changes in labor utilization and the mix of service offerings involving hundreds of studies conducted during any period of time. Selling, general and administrative expenses consist primarily of administrative payroll and related benefit charges, advertising and promotional expenses, administrative travel and an allocation of facility charges and information technology costs, and excludes depreciation and amortization.

Quarterly Results

Covance's quarterly operating results are subject to variation, and are expected to continue to be subject to variation, as a result of factors such as (1) delays in initiating or completing significant drug development trials, (2) termination or reduction in size of drug development trials, (3) acquisitions and divestitures, and (4) exchange rate fluctuations. Delays and terminations of trials are often the result of actions taken by Covance's customers or regulatory authorities and are not typically controllable by Covance. Since a large amount of Covance's operating costs are relatively fixed while revenue is subject to fluctuation, moderate variations in the commencement, progress or completion of drug development trials may cause significant variations in quarterly results.

Results of Operations

Variances explained below are on an "as reported" basis, but also include certain pro forma variances (where so noted) - that is, variances between the three months ended June 30, 2002 and 2001 and between the six months ended June 30, 2002 and 2001, after giving effect to 1) the divestiture of Packaging and Biomanufacturing as if these transactions had occurred on January 1, 2001, 2) the exclusion of the impact of restructuring charges totaling $8,178 ($4,985 net of tax) recorded during the three and six month periods ended June 30, 2001, and 3) the exclusion of goodwill amortization in accordance with the adoption of FASB Statement No. 142 (see "Management's Discussion and Analysis of Financial Condition and Results of Operations - New Accounting Pronouncements" for additional information regarding Statement No. 142).

Three Months Ended June 30, 2002 Compared with Three Months Ended June 30, 2001. Net revenues decreased 3.2% to $219.2 million for the three months ended June 30, 2002 from $226.4 million for the corresponding 2001 period, as the 2001 period includes revenues from Covance's biomanufacturing operations through June 15, 2001. On a proforma basis, net revenues increased 7.5% to $219.2 million for the three months ended June 30, 2002 from $203.9 million for the corresponding 2001 period. Excluding the impact of foreign exchange rate variances between both periods, on a pro forma basis, net revenues increased 6.0% as compared to the corresponding 2001 period. Net revenues from Covance's early development segment grew 16.1%, or 15.1% excluding the impact of foreign exchange rate

variances between both periods, driven primarily by growth in our toxicology service offering. On a pro forma basis, net revenues from Covance's late-stage development segment increased 2.2%, or 0.2% excluding the impact of foreign exchange rate variances between both periods. The modest late-stage development revenue growth was impacted by our strategy to first improve our operating margins by an increased focus on contract selectivity, particularly in our Phase II/III services, and the slower conversion of our backlog to revenue, particularly in our central laboratory business. Our Phase IV and other late-stage service offerings continue to experience solid revenue growth.

Cost of revenue, excluding reimbursable out-of-pocket expenses totaling $10.6 million, decreased 8.0% to $152.3 million or 69.5% of net revenues for the three months ended June 30, 2002 as compared to $165.5 million (excluding reimbursable out-of-pocket expenses totaling $10.3 million) or 73.1% of net revenues for the corresponding 2001 period. Excluding reimbursable out-of-pocket expenses, gross margins were 30.5% for the three months ended June 30, 2002 and 26.9% for the corresponding 2001 period as the 2001 period includes Covance's biomanufacturing operations through June 15, 2001, higher investment spending on internet initiatives and lower margins on bioanalytical services. On a pro forma basis, as a percentage of net revenues, cost of revenue, excluding reimbursable out-of-pocket expenses was 71.9% for the 2001 period.

Overall, selling, general and administrative expenses increased 3.1% to $34.2 million for the three months ended June 30, 2002 from $33.2 million for the corresponding 2001 period. As a percentage of net revenues, selling, general and administrative expenses increased to 15.6% for the three months ended June 30, 2002 from 14.7% for the corresponding 2001 period. On a proforma basis, as a percentage of net revenues, selling, general and administrative expenses were 15.6% for the 2001 period.



Depreciation and amortization decreased 18.9% to $10.2 million or 4.7% of net revenues for the three months ended June 30, 2002 as compared to $12.6 million or 5.6% of net revenues for the corresponding 2001 period, due primarily to the divestiture of our capital intensive biomanufacturing and packaging businesses in the first half of 2001 and the implementation of FASB Statement No. 142 in the first quarter of 2002, which has eliminated the amortization of goodwill. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - New Accounting Pronouncements."

Income from operations increased 221.3% to $22.5 million for the three months ended June 30, 2002 from $7.0 million for the corresponding 2001 period. Income from operations from Covance's early development segment increased $5.8 million or 52.1% to $16.9 million or 18.5% of net revenues for the three months ended June 30 2002 from $11.1 million or 14.1% of net revenues for the corresponding 2001 period, primarily driven by growth in our toxicology services offering. Income from operations from Covance's late-stage development segment increased $13.7 million or 471.9% to $16.6 million or 13.0% of net revenues for the three months ended June 30, 2002 from $2.9 million or 2.0% of net revenues for the corresponding 2001 period.

On a pro forma basis, income from operations increased 41.9% to $22.5 million for the three months ended June 30, 2002 from $15.8 million for the corresponding 2001 period. As a percentage of net revenues on a pro forma basis, income from operations increased to 10.3% for the three months ended June 30, 2002 from 7.8% for the corresponding 2001 period. On a pro forma basis, income from operations from Covance's early development segment increased $5.1 million or 42.8% to $16.9 million as compared to $11.9 million for the three months ended June 30, 2001. On a pro forma basis, income from operations from Covance's late-stage development segment increased $5.6 million or 50.5% to $16.6 million as compared to $11.0 million for the three months ended June 30, 2001. The

increase in late-stage development operating income on a pro forma basis was due to Covance's continued focus on margin improvement in our Phase II/III services mentioned above, margin growth in Phase IV services and reduced spending on internet initiatives.

Other expense, net for the 2001 period includes an $8.4 million pre-tax loss on the sale of businesses. Excluding this loss, other expense, net decreased $0.8 million to $1.7 million for the three months ended June 30, 2002 from $2.4 million for the corresponding 2001 period. This reduction was due to a decrease in interest expense of $2.1 million, resulting from lower weighted average borrowings under our long-term credit facility, partially offset by higher foreign exchange transaction losses reported during the 2002 period, as a result of the weakening U.S. dollar.

Covance's effective tax rate for the three months ended June 30, 2002 increased to 37.0% from 28.8% for the corresponding 2001 period, and decreased from 38.6% for the corresponding 2001 period on a pro forma basis.

Net income was $13.1 million for the three months ended June 30, 2002 versus a loss of $2.8 million for the corresponding 2001 period. On a pro forma basis, net income increased 43.1% or $3.9 million for the three months ended June 30, 2002 as compared to $9.2 million for the corresponding 2001 period.

Six Months Ended June 30, 2002 Compared with Six Months Ended June 30, 2001. Net revenues decreased 6.0% to $427.8 million for the six months ended June 30, 2002 from $455.1 million for the corresponding 2001 period, as the 2001 period includes revenues from Covance's biomanufacturing operations through June 15, 2001 and includes revenues from Covance's packaging operations through February 14, 2001. On a pro forma basis, net revenues increased 7.1% to $427.8 million for the six months ended June 30, 2002 from $399.5 million for the corresponding 2001 period. Excluding the impact of foreign exchange rate variances between both periods, on a pro forma basis, net revenues increased 6.7% as compared to the corresponding 2001 period. Net revenues from Covance's early development services grew 15.7%, or 15.8% excluding the impact of foreign exchange rate variances between both periods, driven primarily by growth in our toxicology service offering. On a pro forma basis, net revenues from Covance's late-stage development segment increased 1.8%, or 1.1% excluding the impact of foreign exchange rate variances between both periods. The modest late-stage development revenue growth was impacted by our strategy to first improve our operating margins by an increased focus on contract selectivity, particularly in our Phase II/III services, and the slower conversion of our backlog to revenue, particularly in our central laboratory business. Our Phase IV and other late-stage service offerings continue to experience solid revenue growth.

Cost of revenue, excluding reimbursable out-of-pocket expenses totaling $20.3 million, decreased 9.5% to $300.4 million or 70.2% of net revenues for the six months ended June 30, 2002 as compared to $332.0 million (excluding reimbursable out-of-pocket expenses totaling $20.2 million) or 73.0% of net revenues for the corresponding 2001 period. Excluding reimbursable out-of-pocket expenses, gross margins were 29.8% for the six months ended June 30, 2002 and 27.0% for the



corresponding 2001 period, as the 2001 period includes Covance's biomanufacturing operations through June 15, 2001 and Covance's packaging operations through February 14, 2001. Also, the 2001 period included higher investment spending on internet initiatives and lower margins on bioanalytical services. On a pro forma basis, as a percentage of net revenues, cost of revenue, excluding reimbursable out-of-pocket expenses was 72.1% for the 2001 period.

Overall, selling, general and administrative expenses were $65.5 million for both the six months ended June 30, 2002 and 2001. As a percentage of net revenues, selling, general and administrative expenses increased to 15.3% for the six months ended June 30, 2002 from 14.4% for the corresponding 2001 period, as the 2001 period includes Covance's biomanufacturing operations through June 15, 2001 and Covance's packaging operations through February 14, 2001. On a pro forma basis, as a percentage of net revenues, selling, general and administrative expenses were 15.3% for the 2001 period.

Depreciation and amortization decreased 22.5% to $20.3 million or 4.7% of net revenues for the six months ended June 30, 2002 from $26.2 million or 5.8% of net revenues for the corresponding 2001 period, due primarily to the divestiture of our capital intensive biomanufacturing and packaging businesses in the first half of 2001, and the implementation of FASB Statement No. 142 in the first quarter of 2002, which has eliminated the amortization of goodwill. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - New Accounting Pronouncements."

Income from operations increased 79.3% to $41.6 million for the six months ended June 30, 2002 from $23.2 million for the corresponding 2001 period. Income from operations from Covance's early development segment increased $8.6 million or 38.5% to $31.1 million or 17.6% of net revenues for the six months ended June 30, 2002 from $22.5 million or 14.7% of net revenues for the corresponding 2001 period, primarily driven by growth in our toxicology services offering. Income from operations from Covance's late-stage development segment increased $17.0 million or 125.7% to $30.6 million or 12.2% of net revenues for the six months ended June 30, 2002 from $13.6 million or 4.5% of net revenues for the corresponding 2001 period.

On a pro forma basis, income from operations increased 34.9% to $41.6 million for the six months ended June 30, 2002 from $30.9 million for the corresponding 2001 period. As a percentage of net revenues on a pro forma basis, income from operations increased to 9.7% for the six months ended June 30, 2002 from 7.7% for the corresponding 2001 period. On a pro forma basis, income from operations from Covance's early development segment increased $7.8 million or 33.4% to $31.1 million as compared to $23.3 million for the six months ended June 30, 2001. On a pro forma basis, income from operations from Covance's late-stage development segment increased $10.3 million or 50.5% to $30.6 million as compared to $20.3 million for the six months ended June 30, 2001. The increase in late-stage development operating income on a pro forma basis was due to Covance's continued focus on margin improvements in our Phase II/III services, and margin growth in Phase IV services.

Other expense, net for the 2001 period includes a $30.8 million net pre-tax gain on the sale of Packaging and Biomanufacturing in the first half of 2001. Excluding this gain, other expense, net decreased $4.8 million to $1.9 million for the six months ended June 30, 2002 from $6.7 million for the corresponding 2001 period, due primarily to a $6.0 million reduction in interest expense resulting from lower weighted average borrowings under our long-term credit facility, partially offset by higher foreign exchange transaction losses reported during the 2002 period, as a result of the weakening U.S. dollar.

Covance's effective tax rate for the six months ended June 30, 2002 and 2001 was 37.5% and 38.6%, respectively. The corresponding pro forma effective tax rate for the 2001 period was 38.6%.

Net income was $24.9 million for the six months ended June 30, 2002 versus $29.1 million for the corresponding 2001 period. On a pro forma basis, net income increased 40.0% or $7.1 million for the six months ended June 30, 2002 as compared to $17.8 million for the corresponding 2001 period.

Liquidity and Capital Resources

Covance's expected primary cash needs on both a short and long-term basis are for capital expenditures, expansion of services, possible future acquisitions, geographic expansion, working capital and other general corporate purposes. On June 28, 2001, Covance replaced its credit facility with a new $150 million senior revolving credit facility ("the Credit Facility"). Covance believes cash from operations and available borrowings under the Credit Facility will provide sufficient liquidity for the foreseeable future. At June 30, 2002 there were no outstanding borrowings and $1.6 million of outstanding letters of credit under the Credit Facility. At December 31, 2001, there was $15.0 million of outstanding borrowings and $0.9 million of outstanding letters of credit under the Credit Facility. Interest on all outstanding borrowings under the Credit Facility is based



upon the London Interbank Offered Rate ("LIBOR") plus a margin and approximated 3.22% per annum for the six month period ended June 30, 2002. Interest on the previous credit facility approximated 7.51% for the same period in 2001. Costs associated with replacing the previous credit facility in June 2001, consisting primarily of bank fees totaling $1.7 million, are being amortized over the three year facility term.

During the six months ended June 30, 2002, Covance's operations provided net cash of $47.4 million, an increase of $43.6 million from the corresponding 2001 period. Cash flows from net earnings adjusted for non-cash activity provided $53.0 million for the six months ended June 30, 2002, up $14.6 million or 38.1% from $38.4 million for the corresponding 2001 period. The change in net operating assets used $5.7 million in cash during the six months ended June 30, 2002 primarily due to a reduction in unearned revenue partially offset by an increase in income taxes payable, while this net change used $34.7 million in cash during the six months ended June 30, 2001, primarily due to a decrease in accrued liabilities and an increase in other current assets. Covance's ratio of current assets to current liabilities was 1.54 at June 30, 2002 and 1.43 at December 31, 2001.

Net days sales outstanding ("DSOs") at June 30, 2002 were 46 days, up from 41 days at December 31, 2001. DSOs have historically followed a seasonal pattern whereby they are generally at their lowest levels at year end and increase during the first six to nine months of the year, before returning to their seasonally lower levels at year end. The impact upon liquidity from a one day change in DSOs is approximately $2 million in cash flow.

Investing activities for the six months ended June 30, 2002 used $19.3 million, compared to using $27.8 million for the corresponding 2001 period, excluding the $251.1 million in proceeds from the sales of Packaging and Biomanufacturing in the first half of 2001. Capital spending for the first six months of 2002 totaled $19.3 million, and was primarily for the expansion of Covance's toxicology capacity, outfitting of new facilities, purchase of new equipment, upgrade of existing equipment and computer equipment and software for newly hired employees. Capital spending for the corresponding 2001 period was primarily for the outfitting of new facilities, purchase of new equipment, upgrade of existing equipment and computer equipment and software for newly hired employees. Planned capital expenditures in 2002 include spending associated with the $27 million expansion of Covance's toxicology capacity in Madison, Wisconsin and the $13 million expansion and enhancement of our Harrogate, England facility.

Foreign Currency

Since Covance operates on a global basis, it is exposed to various

foreign currency risks. Two specific risks arise from the nature of the contracts Covance executes with its customers since from time to time contracts are denominated in a currency different than the particular Covance subsidiary's local currency. These risks are generally applicable only to a portion of the contracts executed by Covance's foreign subsidiaries providing clinical services. The first risk occurs as revenue recognized for services rendered is denominated in a currency different from the currency in which the subsidiary's expenses are incurred. As a result, the subsidiary's net revenues and resultant earnings can be affected by fluctuations in exchange rates. Historically, fluctuations in exchange rates from those in effect at the time contracts were executed have not had a material effect upon Covance's consolidated financial results. See "Risk Factors."

The second risk results from the passage of time between the invoicing of customers under these contracts and the ultimate collection of customer payments against such invoices. Because the contract is denominated in a currency other than the subsidiary's local currency, Covance recognizes a receivable at the time of invoicing for the local currency equivalent of the foreign currency invoice amount. Changes in exchange rates from the time the invoice is prepared and payment from the customer is received will result in Covance receiving either more or less in local currency than the local currency equivalent of the invoice amount at the time the invoice was prepared and the receivable established. This difference is recognized by Covance as a foreign currency transaction gain or loss, as applicable, and is reported in other expense (income) in Covance's Consolidated Statements of Income.

Finally, Covance's consolidated financial statements are denominated in U.S. dollars. Accordingly, changes in exchange rates between the applicable foreign currency and the U.S. dollar will affect the translation of each foreign subsidiary's financial results into U.S. dollars for purposes of reporting Covance's consolidated financial results. The process by which each foreign subsidiary's financial results are translated into U.S. dollars is as follows: income statement accounts are translated at average exchange rates for the period; balance sheet asset and liability accounts are translated at end of period exchange rates; and equity accounts are translated at historical exchange rates. Translation of the balance sheet in this manner affects the stockholders' equity account, referred to as the cumulative translation adjustment account. This account exists only in the foreign subsidiary's U.S. dollar balance sheet and is necessary to keep the foreign balance sheet stated in U.S. dollars in



balance. To date such cumulative translation adjustments have not been material to Covance's consolidated financial position.

Taxes

Since Covance conducts operations on a global basis, Covance's effective tax rate has and will continue to depend upon the geographic distribution of its pre-tax earnings among locations with varying tax rates. Covance's profits are further impacted by changes in the tax rates of the various jurisdictions. In particular, as the geographic mix of Covance's pre-tax earnings among various tax jurisdictions changes, Covance's effective tax rate may vary from period to period.

Inflation

While most of Covance's net revenues are earned under contracts, the long-term contracts (those in excess of one year) generally include an inflation or cost of living adjustment for the portion of the services to be performed beyond one year from the contract date. As a result, Covance believes that the effects of inflation generally do not have a material effect on its operations

or financial condition.

New Accounting Pronouncements

In November 2001, the FASB issued EITF 01-14, Income Statement Characterization of Reimbursements Received for "Out-of-Pocket" Expenses Incurred. This rule requires that in cases where the contractor acts as a principal, reimbursements received for out-of-pocket expenses incurred be characterized as revenue and the associated costs be included as operating expenses in the income statement. Covance implemented this rule beginning with the quarter ended March 31, 2002 and as required, has also reclassified comparative financial information for the three and six months ended June 30, 2001. The implementation of this rule results only in the gross up of revenues and expense and has no impact upon earnings.

In October 2001, the FASB issued Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement was effective for Covance's quarter ended March 31, 2002. These new rules on asset impairment supersede FASB Statement 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of and portions of APB Opinion 30, Reporting the Results of Operations. This Standard provides a single accounting model for long-lived assets to be disposed and significantly changes the criteria that would have to be met to classify an asset as held-for-sale. Classification as held-for-sale is an important distinction since such assets are not depreciated and are stated at the lower of fair value or carrying amount. This statement also requires expected future operating losses from discontinued operations to be displayed in the period(s) in which the losses are incurred, rather than as of the measurement date as presently required. The adoption of this statement did not have a material impact on Covance's results of operations, financial position or cash flows.

In July 2001, the FASB issued Statement No. 142, Goodwill and Other Intangible Assets. This statement requires that goodwill no longer be amortized to earnings, but instead be reviewed for impairment. Covance adopted this statement on January 1, 2002 and accordingly ceased the amortization of goodwill. The adoption of this statement did not have a material impact on Covance's financial position or cash flows, and the impact on diluted earnings per share was $0.01 and $0.02 per share for the three and six months ended June 30, 2002, respectively.

Forward Looking Statements. Statements in this Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as in certain other parts of this Quarterly Report on Form 10-Q that look forward in time, are forward looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward looking statements include statements concerning plans, objectives, goals, strategies, future events or performance, expectations, predictions, and assumptions and other statements which are other than statements of historical facts. All such forward looking statements are based on the current expectations of management and are subject to, and are qualified by, risks and uncertainties that could cause actual results to differ materially from those expressed or implied by those statements. These risks and uncertainties include, without limitation, competitive factors, outsourcing trends in the pharmaceutical industry, the Company's ability to continue to attract and retain qualified personnel, the fixed price nature of contracts or the loss of large contracts, the Company's ability to increase profitability of its clinical development services and to increase order volume in central laboratory services, and continued growth in demand for bioanalytical services and Covance's ability to provide these services on a large scale basis, and other factors described in Covance's filings with the Securities and Exchange Commission including its Annual Report on Form 10-K.

Risk Factors

This section discusses various risk factors that are attendant with our business and the provision of our services. If the events outlined below were to occur individually or in the aggregate, our business, results of operations and financial condition could be materially adversely affected.

Changes in government regulation could decrease the need for the services we provide.

Governmental agencies throughout the world, but particularly in the United States, strictly regulate the drug development process. Our business involves helping pharmaceutical and biotechnology companies navigate the regulatory drug approval process. Changes in regulation, such as a relaxation in regulatory requirements or the introduction of simplified drug approval procedures or an increase in regulatory requirements that we have difficulty satisfying, could eliminate or substantially reduce the need for our services. Also, if government efforts to contain drug costs and pharmaceutical and biotechnology company profits from new drugs, our customers may spend less, or reduce their growth in spending, on research and development.

Failure to comply with existing regulations could result in a loss of revenue or earnings.

Any failure on our part to comply with applicable regulations could result in the termination of on-going research or sales and marketing projects or the disqualification of data for submission to regulatory authorities. For example, if we were to fail to verify that patient participants were fully informed and have fully consented to a particular clinical trial, the data collected from that trial could be disqualified. If this were to happen, we could be contractually required to repeat the trial at no further cost to our customer, but at substantial cost to us.

We may bear financial losses because most of our contracts are of a fixed price nature and may be delayed or terminated or reduced in scope for reasons beyond our control.

As described in our discussion of contractual arrangements in the description of our business, most of our contracts provide for services on a fixed price or fee-for-service with a cap basis and they may be terminated or reduced in scope either immediately or upon notice. Since our contracts are predominantly structured as fixed price or fee-for-service with a cap, we bear the risk of a financial loss if we initially under price our contracts or otherwise overrun our cost estimates. Such under pricing or significant cost overruns could have a material adverse effect on our business, results of operations or financial condition. Cancellations may occur for a variety of reasons, including:

- the failure of products to satisfy safety requirements;
- unexpected or undesired results of the products;
- insufficient patient enrollment;
- insufficient investigator recruitment;
- the client's decision to terminate the development of a product or to end a particular study; and

- our failure to perform properly our duties under the contract.

The loss, reduction in scope or delay of a large contract or the loss or delay of multiple contracts could materially adversely affect our business, although our contracts frequently entitle us to receive the costs of winding down the terminated projects, as well as all fees earned by us up to the time of termination. Some contracts also entitle us to a termination fee, usually in the form of a pre-set penalty or a percentage of the revenue expected to be earned for completion of the project.

We may not be able to successfully develop and market new services.

An important element of our strategy is the successful development and marketing of new services that complement or expand our existing business. If we are unable to (1) develop new services and (2) create demand for those newly developed services, we will not be able to implement this element of our strategy, and our future business, results of operations and financial condition could be adversely affected. For example, we have recently introduced our bioanalytical service offerings. If



demand for these services does not develop as anticipated, our business, financial condition, or results of operations may be materially adversely affected. We cannot assure you that we will be able to develop or market this type of service successfully.

Our quarterly operating results may vary.

Our operating results may vary significantly from quarter to quarter and are influenced by such factors as:

- the commencement, completion or cancellation of large contracts;
- the progress of ongoing contracts;
- the timing of and charges associated with completed acquisitions or other events;
- changes in the mix of our services; and
- exchange rate fluctuations.

We believe that operating results for any particular quarter are not necessarily a meaningful indication of future results. While fluctuations in our quarterly operating results could negatively affect the market price of our common stock, these fluctuations may not be related to our future overall operating performance.

We depend on the pharmaceutical and biotechnology industries.

Our revenues depend greatly on the expenditures made by the pharmaceutical and biotechnology industries in research and development. Accordingly, economic factors and industry trends that affect our clients in these industries also affect our business. For example, the practice of many companies in these industries has been to hire outside organizations such as ourselves to conduct large clinical research and development projects. This practice has grown significantly in the last decade, and we have benefited from this trend. However, if this trend were to change and companies in these industries were to reduce the number of research and development projects they outsource, our business could be materially adversely affected.

We operate in a highly competitive industry.

Competitors in the contract research organization industry range from small, limited-service providers to full service global contract research organizations. Our main competition consists of in-house departments of pharmaceutical companies, full-service contract research organizations, and universities and teaching hospitals, although to a lesser degree. We compete on a variety of factors, including:

- reputation for on-time quality performance;
- expertise and experience in specific areas;
- scope of service offerings;
- strengths in various geographic markets;
- price;
- technological expertise and efficient drug development processes;
- ability to acquire, process, analyze and report data in a time-saving and accurate manner;
- ability to manage large-scale clinical trials both domestically and internationally;
- expertise and experience in health economics and outcomes services; and
- size.



For instance, our clinical development services have from time to time experienced periods of increased price competition which had a material adverse effect on Covance's late-stage development profitability and consolidated net revenues and net income. Covance took actions in 2000 to mitigate the effects of this price competition; however, if market conditions were to deteriorate, additional actions might be required in the future.

There is competition among the larger contract research organizations for both clients and potential acquisition candidates. Additionally, small, limited-service entities considering entering the contract research organization industry will find few barriers to entry, thus further increasing possible competition.

Finally, an increase in investment community interest in our industry could result in an increased availability of financial resources for contract research organizations. Such availability of resources could lead to increased competition. We cannot assure you that competing pressures we face will not have a material effect on us.

We may expand our business through acquisitions.

We review many acquisition candidates and, in addition to acquisitions which we have already made, we are continually evaluating new acquisition opportunities. Factors which may affect our ability to grow successfully through acquisitions include:

- difficulties and expenses in connection with integrating the acquired company and achieving the expected benefits;

- diversion of management's attention from current operations;
- the possibility that we may be adversely affected by risk factors facing the acquired companies;
- acquisitions could be dilutive to earnings, or in the event of acquisitions made through the issuance of our common stock to the shareholders of the acquired company, dilutive to the percentage of ownership of our existing stockholders;
- potential losses resulting from undiscovered liabilities of acquired companies not covered by the indemnification we may obtain from the seller;
- risks of not being able to overcome differences in foreign business practices, language and other cultural barriers in connection with the acquisition of foreign companies; and
- loss of key employees of the acquired company.

We may be affected by potential health care reform.

In recent years the United States Congress and state legislatures have considered various types of health care reform in order to control growing health care costs. Health care reform may again be addressed by the United States Congress and state legislatures. We are unable to predict what legislative proposals will be adopted in the future, if any. Similar reform movements have occurred in Europe and Asia.

Implementation of health care reform legislation that contain costs could limit the profits that can be made from the development of new drugs. This could adversely affect research and development expenditures by pharmaceutical and biotechnology companies which could in turn decrease the business opportunities available to us both in the United States and abroad. In addition, new laws or regulations may create a risk of liability, increase our costs or limit our service offerings. We cannot predict the likelihood of any of these events.



Our revenues and earnings are exposed to exchange rate fluctuations.

We derive a large portion of our net revenues from international operations. For the six month period ended June 30, 2002, we derived approximately 33% of our net revenues from outside the United States. Our financial statements are denominated in U.S. dollars. As a result, factors associated with international operations, including changes in foreign currency exchange rates, could significantly affect our results of operations and financial condition.

The loss of our key personnel could adversely affect our business.

Our success depends to a significant extent upon the efforts of our senior management team and other key personnel. We do not maintain insurance on the life of any of our employees. The loss of the services of such personnel could adversely affect our business. Because of the nature of our business, our success is dependent upon our ability to attract and retain technologically qualified personnel. There is substantial competition for qualified personnel, and we cannot assure you that we will be successful in recruiting or retaining qualified personnel to enable us to conduct our business and compete effectively

in our industry.

Our contract research services create a risk of liability.

In connection with many clinical trials, we contract with physicians, also referred to as investigators, to conduct the clinical trials to test new drugs on human volunteers. These tests can create a risk of liability for personal injury or death to volunteers, resulting from negative reactions to the drugs administered or from professional malpractice by third party investigators, particularly to volunteers with life-threatening illnesses. We do not believe we are legally accountable for the medical care rendered by third-party investigators and we seek to limit our liability with trial sponsors, third party investigators and others. However, it is possible that we could be exposed to liability. For example, we could be held liable for the following:

- our errors or omissions that create harm during a trial to study volunteers or after a trial to consumers of the drug after regulatory approval of the drug;
- general risks associated with our Phase I facilities, including negative consequences from the administration of drugs to clinical trial participants or the professional malpractice of Phase I medical care providers;
- errors or omissions by our preclinical or central laboratories that cause harm to study volunteers or consumers of an approved drug;
- errors or omissions by our preclinical laboratories arising from our tests conducted for the agrochemical and food industries; and
- risks that animals in our breeding facilities may be infected with diseases that may be harmful and even lethal to themselves and humans despite preventive measures contained in our company policies for the quarantine and handling of imported animals.

We believe that our risks are generally reduced by the following:

- contracts with our clients and, where applicable, investigators containing provisions entitling us to be indemnified by them;
- insurance maintained by our clients, investigators, where applicable, and by us; and
- various regulatory requirements we must follow in connection with our business.

Contractual indemnifications generally do not protect us against liability arising from certain of our own actions, such as negligence. We could be materially and adversely affected if we were required to pay damages or bear the costs of defending any claim (1) which is not covered by a contractual indemnification provision, (2) in the event that a party who must indemnify us does not fulfill its indemnification obligations or (3) which is beyond the level of our insurance coverage. There can be no assurance that we will be able to maintain such insurance coverage on terms acceptable to us.



Reliance on air transportation.

Our central laboratories and, to a lesser extent, our other businesses, are heavily reliant on air travel for transport of clinical trial kits and other

material and people, and disruption to the air travel system could have a material adverse effect on our business. While we have developed contingency plans for a variety of events that could disrupt or limit available air transportation, there are no assurances that such plans will be effective or sufficient to avert such a material adverse effect.

Actions of animal rights extremists may affect our business.

Our early development services utilize animals (predominantly rodents) in preclinical testing of the safety and efficacy of drugs and also breeds and sell animals for biomedical research. Acts of vandalism and other acts by animal rights extremists who object to the use of animals in drug development could have a material adverse effect on our business.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Our $150.0 million credit facility is U.S. Dollar denominated and is not subject to transaction or translation exposure. Interest on all outstanding borrowings under this credit facility is based upon LIBOR plus a margin and approximated 3.22% per annum for the six months ended June 30, 2002. At June 30, 2002 we did not have any outstanding borrowings under our credit facility.

For the six months ended June 30, 2002, approximately 33% of our net revenues were from outside the United States. We do not engage in derivative or hedging activities related to our potential foreign exchange exposures. See "Management's Discussion and Analysis of Financial Condition and Results of Operations - Foreign Currency" for a more detailed discussion of our foreign currency risks and exposures.



Part II. Other Information

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

The Annual Meeting of Stockholders of Covance was held on May 7, 2002, pursuant to notice.

The following table sets forth the number of votes cast for, against or withheld, as well as the number of abstentions and broker non-votes, as to each matter voted on at the meeting:

| Proposal | Number of Votes For | Number of Votes Withheld |
|---|---|---|
| To elect three members to the Covance Class II Board of Directors: | | |
| J. Randall MacDonald | 54,306,977 | 1,088,474 |
| Kathleen G. Murray | 54,352,502 | 1,042,949 |
| William C. Ughetta | 54,368,952 | 1,026,499 |

| Proposal | Number of Votes For | Number of Votes Against | Number of Abstentions | Broke |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| To approve the 2002 Employee Equity Participation Plan | 39,307,628 | 8,771,968 | 1,362,244 | 5 |

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Not Applicable

(b) Reports on Form 8-K

During the three month period ended June 30, 2002, no reports on Form 8-K were filed.



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.

COVANCE INC.

Dated: July 26, 2002

By: /s/ CHRISTOPHER A. KUEBLER
Christopher A. Kuebler
Chairman of the Board
and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ CHRISTOPHER A. KUEBLER<br>Christopher A. Kuebler | Chairman of the Board and Chief Executive Officer (Principal Executive Officer) | July 26, 2002 |
| /s/ WILLIAM E. KLITGAARD<br>William E. Klitgaard | Corporate Senior Vice President and Chief Financial Officer (Principal Financial Officer) | July 26, 2002 |
| /s/ MICHAEL GIANNETTO<br>Michael Giannetto | Corporate Vice President and Controller (Principal Accounting Officer) | July 26, 2002 |

22