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CRITICARE SYSTEMS INC /DE/
Form 10-Q
May 10, 2001

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 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 number -0-16061

CRITICARE SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware

39-1501563

(State or other jurisdiction
of incorporation or organization)

(IRS Employer Identification No.)

20925 Crossroads Circle, Waukesha, Wisconsin

53186

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number including area code (262) 798-8282

N/A

Former name, former address and former fiscal year, if changed since last report.

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

Number of shares outstanding of each class of the registrant's classes of common stock as of March 31, 2001: Class A Common Stock 10,779,524 shares.

CRITICARE SYSTEMS, INC.

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CONSOLIDATED BALANCE SHEETS
MARCH 31, 2001 AND JUNE 30, 2000

(UNAUDITED)

| ASSETS | March 31, 2001 | June 30, 2000 |
|---|-------------------|------------------|
| | ----- | ----- |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 2,742,445 | \$ 114,830 |
| Accounts receivable, less allowance for doubtful accounts of \$1,000,000 and \$1,300,000, respectively | 7,223,329 | 6,782,765 |
| Investments | 2,624,151 | 5,704,675 |
| Other receivables | 95,719 | 116,773 |
| Inventories | 7,966,373 | 8,178,326 |
| Prepaid expenses | 435,017 | 219,852 |
| | ----- | ----- |
| Total current assets | 21,087,034 | 21,117,221 |
| Property, plant and equipment - net | 6,039,084 | 5,988,656 |
| License rights and patents - net | 100,640 | 104,990 |
| TOTAL | \$27,226,758 | \$27,210,867 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 2,340,523 | \$ 2,635,344 |
| Accrued liabilities: | | |
| Compensation and commissions | 919,582 | 1,243,839 |
| Product warranties | 334,900 | 325,000 |
| Other | 485,798 | 574,826 |
| Current maturities of long-term debt | 85,114 | 80,432 |
| | ----- | ----- |
| Total current liabilities | 4,165,917 | 4,859,441 |
| LONG-TERM DEBT, less current maturities | 3,218,957 | 3,283,892 |
| OTHER LONG-TERM OBLIGATIONS | 92,382 | 268,582 |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock | - | - |
| Common stock - \$.04 par value, 15,000,000 shares authorized, 10,779,524 and 8,976,251 shares issued, respectively | 431,181 | 359,050 |
| Additional paid-in capital | 22,459,856 | 18,478,040 |
| Common stock held in treasury (67,692 and 81,122 shares, respectively) | (126,919) | (151,111) |
| Retained earnings (accumulated deficit) | (5,638,767) | (5,591,702) |
| Accumulated comprehensive income | 2,624,151 | 5,704,675 |
| | ----- | ----- |
| Total stockholders' equity | 19,749,502 | 18,798,952 |
| | ----- | ----- |
| TOTAL | \$27,226,758 | \$27,210,867 |
| | ===== | ===== |

See notes to consolidated financial statements.

CRITICARE SYSTEMS, INC.
CONSOLIDATED INCOME STATEMENTS
NINE MONTHS ENDED MARCH 31, 2001 AND 2000

(UNAUDITED)

| | 2001 | 2000 |
|--|--------------|--------------|
| | ----- | ----- |
| NET SALES | \$20,057,979 | \$19,634,951 |
| COST OF GOODS SOLD | 12,043,031 | 11,269,345 |
| | ----- | ----- |
| GROSS PROFIT | 8,014,948 | 8,365,606 |
| OPERATING EXPENSES: | | |
| Marketing | 4,376,088 | 5,472,763 |
| Research, development and engineering | 1,773,657 | 2,278,059 |
| Administrative | 1,802,055 | 1,815,938 |
| | ----- | ----- |
| Total | 7,951,800 | 9,566,760 |
| INCOME (LOSS) FROM OPERATIONS | 63,148 | (1,201,154) |
| OTHER INCOME (EXPENSE): | | |
| Interest expense | (190,766) | (195,408) |
| Interest income | 110,873 | 77,759 |
| Gain on sale of stock | - | 2,500,000 |
| | ----- | ----- |
| Total | (79,893) | 2,382,351 |
| (LOSS) INCOME BEFORE INCOME TAXES . . | (16,745) | 1,181,197 |
| INCOME TAX PROVISION | - | - |
| | ----- | ----- |
| NET (LOSS) INCOME | \$ (16,745) | \$ 1,181,197 |
| | ===== | ===== |
| NET (LOSS) INCOME PER COMMON SHARE: | | |
| Basic | \$ 0.00 | \$ 0.14 |
| Diluted | na | \$ 0.13 |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 9,988,834 | 8,630,390 |
| Diluted | na | 8,861,107 |

See notes to consolidated financial statements.

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THREE MONTHS ENDED MARCH 31, 2001 AND 2000

(UNAUDITED)

| | 2001 | 2000 |
|--|--------------|----------------|
| | ----- | ----- |
| NET SALES | \$ 7,263,979 | \$ 6,130,915 |
| COST OF GOODS SOLD. | 4,340,626 | 3,896,086 |
| | ----- | ----- |
| GROSS PROFIT. | 2,923,353 | 2,234,829 |
| OPERATING EXPENSES: | | |
| Marketing | 1,571,937 | 1,929,333 |
| Research, development and engineering | 641,375 | 713,397 |
| Administrative. | 672,854 | 735,267 |
| | ----- | ----- |
| Total | 2,886,166 | 3,377,997 |
| INCOME (LOSS) FROM OPERATIONS | 37,187 | (1,143,168) |
| OTHER INCOME (EXPENSE): | | |
| Interest expense. | (62,097) | (64,895) |
| Interest income | 68,477 | 10,345 |
| | ----- | ----- |
| Total | 6,380 | (54,550) |
| INCOME (LOSS) BEFORE INCOME TAXES . . | 43,567 | (1,197,718) |
| INCOME TAX PROVISION. | - | - |
| | ----- | ----- |
| NET INCOME (LOSS) | \$ 43,567 | \$ (1,197,718) |
| | ===== | ===== |
| NET INCOME (LOSS) PER COMMON SHARE: | | |
| Basic | \$ 0.00 | \$ (0.14) |
| Diluted | \$ 0.00 | \$ (0.14) |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 10,709,603 | 8,684,029 |
| Diluted | 11,023,740 | 8,684,029 |

See notes to consolidated financial statements.

CRITICARE SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
NINE MONTHS ENDED MARCH 31, 2001 AND 2000

(UNAUDITED)

2001

2000

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| | | |
|--|-------------|--------------|
| OPERATING ACTIVITIES: | | |
| Net (loss) income | \$ (16,745) | \$ 1,181,197 |
| Adjustments to reconcile net (loss) income to net cash used in operating activities: | | |
| Depreciation | 577,022 | 724,982 |
| Amortization | 4,350 | 13,500 |
| Provision for doubtful accounts | (300,000) | - |
| Obsolescence reserve | (75,000) | - |
| Gain on sale of Immtech stock | - | (2,500,000) |
| Litigation settled with common stock | - | 69,375 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (140,564) | (195,250) |
| Other receivables | 21,054 | (41,331) |
| Inventories | 148,941 | (774,636) |
| Prepaid expenses | (215,165) | (42,712) |
| Accounts payable | (294,821) | (268,909) |
| Accrued liabilities | (579,585) | (2,448,015) |
| Net cash used in operating activities | (870,513) | (4,281,799) |
| INVESTING ACTIVITIES: | | |
| Purchases of property, plant and equipment, net | (489,438) | (418,688) |
| Proceeds from sale of Immtech stock | - | 2,500,000 |
| Net cash (used in) provided by investing activities | (489,438) | 2,081,312 |
| FINANCING ACTIVITIES: | | |
| Principal payments on long-term debt | (60,253) | (55,236) |
| Proceeds from issuance of common stock | 4,047,819 | 477,629 |
| Net cash provided by financing activities | 3,987,566 | 422,393 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 2,627,615 | (1,778,094) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 114,830 | 2,511,078 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$2,742,445 | \$ 732,984 |

See notes to consolidated financial statements.

CRITICARE SYSTEMS, INC.
Condensed Notes to Consolidated Financial Statements
(Unaudited)

1. BASIS OF PRESENTATION

The accompanying unaudited financial statements have been prepared by Criticare Systems, Inc. (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") and, in the opinion of the Company, include all adjustments necessary for a fair statement of results for each period shown. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such SEC rules and regulations. The Company believes that the disclosures made are adequate to prevent the financial information given from being misleading. It is suggested that these financial statements be read in conjunction with the financial

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statements and notes thereto included in the Company's latest annual report and previously filed Form 10-K.

2. INVENTORY VALUATION

Inventory is stated at the lower of cost or market, with cost determined on the first-in, first-out method. Components of inventory consisted of the following at March 31, 2001 and June 30, 2000, respectively:

| | March 31, 2001 | June 30, 2000 |
|--------------------------------|----------------|---------------|
| Component parts | \$ 4,111,427 | \$ 3,721,474 |
| Work in process | 996,064 | 1,169,609 |
| Finished units | 3,183,882 | 3,687,243 |
| | 8,291,373 | 8,578,326 |
| Total inventories | 8,291,373 | 8,578,326 |
| Less: reserve for obsolescence | 325,000 | 400,000 |
| | 7,966,373 | 8,178,326 |
| Net inventory | \$ 7,966,373 | \$ 8,178,326 |

3. INVESTMENTS

During August, September and October 1999, the Company sold 500,000 shares of Immtech International, Inc. ("Immtech") stock for \$2,500,000 in a private placement. The funds were used primarily to settle a long-standing lawsuit, which was settled in July 1999. The Company held 456,374 shares of Immtech stock, which was trading at \$5-3/4 per share, on March 30, 2001. The market value of these shares could change substantially due to overall market risk.

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4. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of the following:

| | March 31, 2001 | June 30, 2000 |
|---------------------------------------|----------------|---------------|
| Land and building | \$ 4,525,000 | \$ 4,525,000 |
| Machinery and equipment | 2,088,508 | 2,009,312 |
| Furniture and fixtures | 865,029 | 763,282 |
| Production tooling | 2,959,640 | 2,651,145 |
| Demonstration and loaner monitors . . | 1,545,599 | 1,407,587 |
| | 11,983,776 | 11,356,326 |
| Property, plant and equipment - cost | 11,983,776 | 11,356,326 |
| Less: accumulated depreciation . . | 5,944,692 | 5,367,670 |
| | 6,039,084 | 5,988,656 |
| Property, plant and equipment - net. | \$ 6,039,084 | \$ 5,988,656 |

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CRITICARE SYSTEMS, INC.
Management's Discussion and Analysis of
Results of Operations and Financial Condition
Nine Months Ended March 31, 2001 and 2000

RESULTS OF OPERATIONS

Net sales for the nine months ended March 31, 2001 increased 2% from the same period in the prior year. However, two significant and isolated sales in the prior year, combined with the partial return of product from one of these sales in the current year, had the effect of increasing the prior year and reducing the current year revenue. Adjusting for these items, the net sales in 2001 increased almost \$2.5 million, or 14%, above the same period in the prior year. Approximately \$2.1 million of this increase can be attributed to higher OEM sales, which have become a significant contributor to revenue in fiscal 2001.

The gross profit percentage was 40% for the first nine months of the current year compared to 42.6% for the same period in fiscal 2000. Margins fell in the last two quarters of fiscal 2000, but rebounded to the 40% level in the first quarter of fiscal 2001, where they have remained for all three quarters of the current fiscal year. Margins in the current year were favorably impacted by the recognition of \$105,000 in deferred income from the settlement of a contract that was agreed to in January 2000 and fully satisfied in the third quarter of fiscal 2001 and from a \$75,000 reduction in a reserve for obsolete inventory. The Company expects to see improvement in its margins after fiscal 2001 as a result of lower product costs expected from outsourcing the manufacturing of the majority of its product lines to foreign manufacturers and from anticipated cost efficiencies from increased sales volume generated from new products introduced late in fiscal 2000. See "Forward-Looking Statements."

The Company has continued to make a concerted effort to reduce operating expenses in order to negate the impact of declining margins from pricing pressures on medical monitoring systems worldwide. A reduction in operating expenses of over \$1.6 million in the current year more than offset the lower margins realized in the first nine months of fiscal 2001. \$300,000 of this reduction was a reversal of previously recorded bad debt expense related to the sales return mentioned above. However, the remaining \$1.3 million in expense savings relates to more tangible spending reductions. Approximately \$800,000 of this total is attributed to more cost-effective spending in marketing on travel, consulting fees, trade shows and other sales promotion expenses, and sales commissions. The final \$500,000 in lower spending was due to significant engineering project expenses incurred in the first nine months of the prior year related to the development of new products that were released in late fiscal 2000. The overall \$1.6 million savings in operating expenses more than offset the lower margins, resulting in a small profit from operations for the first nine months of the current year which was significantly better than the \$1.2 million loss from operations that was generated in the prior year period.

Other income and expense is comparable to that of the prior year period with the exception of the \$2.5 million gain recorded in fiscal 2000. This gain relates to the private placement sale of a portion of the stock in Immtech International, Inc. in which the Company still has a position. The large gain allowed the Company to recognize net income of \$1.2 million in the first nine months of the prior year, compared to the small net loss produced in the current year period.

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Results of Operations and Financial Condition
Three Months Ended March 31, 2001 and 2000

RESULTS OF OPERATIONS

Net sales for the three months ended March 31, 2001 increased 18% to \$7.3 million from \$6.1 million for the same period in fiscal 2000. A significant increase in sales internationally drove the majority of the higher revenue between quarters as the new POET line of monitors introduced late in fiscal 2000 favorably impacted fiscal 2001 third quarter revenue. In addition, for the third consecutive quarter in fiscal 2001, OEM sales improved over the prior year, enabling the Company to increase sales in each quarter of the current fiscal year.

The gross profit percentage was 40.2% for the three months ended March 31, 2001 compared to 36.5% for the same period in the prior year. The recognition of deferred income in the third quarter of fiscal 2001, combined with the reduction in the obsolescence reserve, both discussed previously, favorably impacted margins. Increased sales volume of the Company's high margin accessory business accounted for the remainder of the margin improvement between quarters.

The Company's concerted efforts to reduce operating expenses continued in the third quarter of fiscal 2001 as operating expenses were reduced almost \$500,000 compared to the same period in the prior year. The majority of this decrease was realized through cost-effective marketing expense reductions in the areas of travel, consulting fees, and trade show spending. Another \$100,000 in expense savings was realized from the reversal of bad debt expense recorded in the first quarter of fiscal 2001 for loaner equipment that was no longer deemed at risk due to favorable collections experience.

The higher sales volume, improved gross profit performance, and lower operating expenses discussed above for the three months ended March 31, 2001 produced a small amount of income from operations which was significantly better than the \$1,143,000 loss from operations that was generated for the same period in the prior year. In addition, a \$58,000 increase in interest income earned from the investment of proceeds received in October 2000 from the private placement of shares of the Company's common stock more than offset the interest expense incurred on the mortgage of the Company's facility. As a result, the Company generated net income slightly better than breakeven for the second consecutive quarter, compared to the \$1.2 million net loss in the fiscal third quarter of the prior year.

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CRITICARE SYSTEMS, INC.
Management's Discussion and Analysis of
Results of Operations and Financial Condition

LIQUIDITY

As of March 31, 2001, the Company had a cash balance of approximately \$2.7 million and no short-term borrowings. In the nine months ended March 31, 2001, approximately \$871,000 of cash was used in operations to support the transition of manufacturing to contract suppliers, and another \$489,000 was invested in property, plant and equipment. These items were funded by \$4.0 million in proceeds received in October 2000 from the private placement of shares of the Company's common stock. The primary intended use of these proceeds is to fund additional research and development efforts and to expand the Company's marketing programs. In the nine months ended March 31, 2000, approximately \$4.3

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million was used in operations, of which a significant portion was attributed to the settlement of a long-standing lawsuit. Proceeds for this settlement were obtained from the sale of 500,000 shares of Immtech stock for \$2.5 million in a private placement sale. The Company believes all future capital and liquidity requirements will be satisfied by cash generated from operations, its current cash balances and periodic utilization of a \$4,000,000 line of credit currently in place, if necessary. At March 31, 2001, there were no borrowings outstanding under the line of credit.

FORWARD LOOKING STATEMENTS

A number of the matters and subject areas discussed herein that are not historical or current facts deal with potential future circumstances and developments. These include anticipated product introductions, expected future financial results, liquidity needs, financing ability, management's or the Company's expectations and beliefs and similar matters discussed in Management's Discussion and Analysis or elsewhere herein. The discussions of such matters and subject areas are qualified by the inherent risk and uncertainties surrounding future expectations generally, and also may materially differ from the Company's actual future experience.

The Company's business, operations and financial performance are subject to certain risks and uncertainties which could result in material differences in actual results from management's or the Company's current expectations. These risks and uncertainties include, but are not limited to, general economic conditions, demand for the Company's products, costs of operations, the development of new products, the reliance on single sources of supply for certain components in the Company's products, government regulation, health care cost containment programs, the effectiveness of the Company's programs to manage working capital and reduce costs, unanticipated difficulties as the Company begins to outsource the manufacturing of the majority of its products to foreign manufacturers and risks related to foreign manufacturing, including economic and political instability, trade and foreign tax laws, production delays and cost overruns and quality control, and competition in the Company's markets.

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PART II - OTHER INFORMATION

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits:

- 3.1 Restated Certificate of Incorporation of the Company (incorporated by reference to the Registration Statement filed on Form S-1, Registration No. 33-13050).
- 3.2 By-Laws of the Company (incorporated by reference to the Registration Statement filed on Form S-1, Registration No. 33-13050).
- 4.1 Specimen Common Stock certificate (incorporated by reference to the Registration Statement filed on Form S-1, Registration No. 33-13050).

(b) Reports on Form 8-K. The Company did not file any reports on Form 8-K during the quarter ended March 31, 2001.

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.

CRITICARE SYSTEMS, INC.
(Registrant)

Date May 10, 2001

BY /s/ Michael J. Sallmann

Michael J. Sallmann
Vice President - Finance
(Chief Accounting Officer and
Duly Authorized Officer)