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CRITICARE SYSTEMS INC /DE/
Form 10-Q
February 09, 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 December 31, 2000

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 December 31, 2000: Class A Common Stock - 10,778,524 shares.

CRITICARE SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS

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DECEMBER 31, 2000 AND JUNE 30, 2000

(UNAUDITED)

| ASSETS | December 31, 2000 | June 30 2000 |
|---|----------------------|-----------------|
| | ----- | ----- |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 3,527,457 | \$ 114,8 |
| Accounts receivable, less allowance for doubtful accounts of \$1,100,000 and \$1,300,000, respectively | 6,915,419 | 6,782,7 |
| Investments | 4,449,647 | 5,704,6 |
| Other receivables | 98,647 | 116,7 |
| Inventories | 7,794,206 | 8,178,3 |
| Prepaid expenses | 458,510 | 219,8 |
| | ----- | ----- |
| Total current assets | 23,243,886 | 21,117,2 |
| Property, plant and equipment - net | 6,003,235 | 5,988,6 |
| License rights and patents - net | 96,890 | 104,9 |
| TOTAL | \$ 29,344,011 | \$27,210,8 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 2,367,769 | \$ 2,635,3 |
| Accrued liabilities: | | |
| Compensation and commissions | 1,081,719 | 1,243,8 |
| Product warranties | 325,000 | 325,0 |
| Other | 549,926 | 574,8 |
| Current maturities of long-term debt | 83,548 | 80,4 |
| | ----- | ----- |
| Total current liabilities | 4,407,962 | 4,859,4 |
| LONG-TERM DEBT, less current maturities | 3,241,669 | 3,283,8 |
| OTHER LONG-TERM OBLIGATIONS | 142,383 | 268,5 |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock | - | |
| Common stock - \$.04 par value, 15,000,000 shares authorized, 10,778,524 and 8,976,251 shares issued, respectively | 431,141 | 359,0 |
| Additional paid-in capital | 22,457,885 | 18,478,0 |
| Common stock held in treasury (72,288 and 81,122 shares, respectively) | (134,656) | (151,1 |
| Retained earnings (accumulated deficit) | (5,652,020) | (5,591,7 |
| Accumulated comprehensive income | 4,449,647 | 5,704,6 |
| | ----- | ----- |
| Total stockholders' equity | 21,551,997 | 18,798,9 |
| | ----- | ----- |
| TOTAL | \$ 29,344,011 | \$27,210,8 |
| | ===== | ===== |

See notes to consolidated financial statements.

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CRITICARE SYSTEMS, INC.
CONSOLIDATED INCOME STATEMENTS
SIX MONTHS ENDED DECEMBER 31, 2000 AND 1999

(UNAUDITED)

| | 2000 | 1999 |
|--|--------------|--------------|
| | ----- | ----- |
| NET SALES | \$12,794,000 | \$13,504,036 |
| COST OF GOODS SOLD. | 7,702,405 | 7,373,259 |
| | ----- | ----- |
| GROSS PROFIT. | 5,091,595 | 6,130,777 |
| OPERATING EXPENSES: | | |
| Marketing | 2,804,151 | 3,543,432 |
| Research, development and engineering | 1,132,282 | 1,564,662 |
| Administrative. | 1,129,201 | 1,080,671 |
| | ----- | ----- |
| Total | 5,065,634 | 6,188,765 |
| INCOME (LOSS) FROM OPERATIONS | 25,961 | (57,988) |
| OTHER INCOME (EXPENSE): | | |
| Interest expense. | (128,669) | (130,513) |
| Interest income | 42,396 | 67,413 |
| Gain on sale of stock | - | 2,500,000 |
| | ----- | ----- |
| Total | (86,273) | 2,436,900 |
| (LOSS) INCOME BEFORE INCOME TAXES. . | (60,312) | 2,378,912 |
| INCOME TAX PROVISION. | - | - |
| | ----- | ----- |
| NET (LOSS) INCOME | \$ (60,312) | \$ 2,378,912 |
| | ===== | ===== |
| NET (LOSS) INCOME PER COMMON SHARE | | |
| Basic | \$ (0.01) | \$ 0.27 |
| Diluted | na | \$ 0.26 |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 9,636,284 | 8,707,809 |
| Diluted | na | 9,004,686 |

See notes to consolidated financial statements.

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CRITICARE SYSTEMS, INC.

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CONSOLIDATED INCOME STATEMENTS
THREE MONTHS ENDED DECEMBER 31, 2000 AND 1999

(UNAUDITED)

| | 2000 | 1999 |
|--|--------------|-------------|
| | ----- | ----- |
| NET SALES | \$ 6,564,123 | \$6,900,699 |
| COST OF GOODS SOLD. | 3,983,575 | 3,758,733 |
| | ----- | ----- |
| GROSS PROFIT. | 2,580,548 | 3,141,966 |
| OPERATING EXPENSES: | | |
| Marketing | 1,329,042 | 1,937,053 |
| Research, development and engineering | 551,000 | 853,206 |
| Administrative. | 566,963 | 566,670 |
| | ----- | ----- |
| Total | 2,447,005 | 3,356,929 |
| INCOME (LOSS) FROM OPERATIONS | 133,543 | (214,963) |
| OTHER INCOME (EXPENSE): | | |
| Interest expense. | (63,862) | (64,732) |
| Interest income | 35,977 | 38,131 |
| Gain on sale of stock | - | 740,000 |
| | ----- | ----- |
| Total | (27,885) | 713,399 |
| INCOME BEFORE INCOME TAXES | 105,658 | 498,436 |
| INCOME TAX PROVISION. | - | - |
| | ----- | ----- |
| NET INCOME. | \$ 105,658 | \$ 498,436 |
| | ===== | ===== |
| NET INCOME PER COMMON SHARE | | |
| Basic | \$ 0.01 | \$ 0.06 |
| Diluted | \$ 0.01 | \$ 0.06 |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 10,373,962 | 8,707,809 |
| Diluted | 10,517,441 | 9,004,686 |

See notes to consolidated financial statements.

CRITICARE SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
SIX MONTHS ENDED DECEMBER 31, 2000 AND 1999

(UNAUDITED)

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| | 2000 | 1999 |
|---|-------------|--------------|
| | ----- | ----- |
| OPERATING ACTIVITIES: | | |
| Net (loss) income | \$ (60,312) | \$ 2,378,912 |
| Adjustments to reconcile net (loss) income to net cash used in operating activities: | | |
| Depreciation | 320,837 | 450,843 |
| Amortization | 8,100 | 9,000 |
| Provision for doubtful accounts | (200,000) | - |
| Gain on sale of Immtech stock | - | (2,500,000) |
| Changes in assets and liabilities: | | |
| Accounts receivable | 67,346 | (34,861) |
| Other receivables | 18,126 | 78,845 |
| Inventories | 306,044 | (99,794) |
| Prepaid expenses | (238,658) | (215,055) |
| Accounts payable | (267,575) | (593,357) |
| Accrued liabilities | (313,219) | (2,017,687) |
| | ----- | ----- |
| Net cash used in operating activities | (359,311) | (2,543,154) |
| INVESTING ACTIVITIES: | | |
| Purchases of property, plant and equipment, net | (257,340) | (317,212) |
| Proceeds from sale of Immtech stock | - | 2,500,000 |
| | ----- | ----- |
| Net cash (used in) provided by investing activities | (257,340) | 2,182,788 |
| FINANCING ACTIVITIES: | | |
| Principal payments on long-term debt | (39,107) | (36,244) |
| Proceeds from issuance of common stock | 4,068,385 | - |
| | ----- | ----- |
| Net cash provided by (used in) financing activities | 4,029,278 | (36,244) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 3,412,627 | (396,610) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 114,830 | 2,511,078 |
| | ----- | ----- |
| CASH AND CASH EQUIVALENTS, END OF YEAR | \$3,527,457 | \$ 2,114,468 |
| | ===== | ===== |

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

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that these financial statements be read in conjunction with the financial 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 December 31 and June 30, 2000, respectively:

| | December 31, 2000 | June 30, 2000 |
|--------------------------------|-------------------|---------------|
| Component parts | \$ 3,431,280 | \$ 3,721,474 |
| Work in process | 1,230,727 | 1,169,609 |
| Finished units. | 3,532,199 | 3,687,243 |
| | 8,194,206 | 8,578,326 |
| Total inventories | 8,194,206 | 8,578,326 |
| Less: reserve for obsolescence | 400,000 | 400,000 |
| | 7,794,206 | 8,178,326 |
| Net inventory | \$ 7,794,206 | \$ 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 \$9-3/4 per share, on December 31, 2000. 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:

| | December 31, 2000 | June 30, 2000 |
|--------------------------------------|-------------------|---------------|
| Land and building. | \$ 4,525,000 | \$ 4,525,000 |
| Machinery and equipment. | 2,058,456 | 2,009,312 |
| Furniture and fixtures | 848,755 | 763,282 |
| Production tooling | 2,773,868 | 2,651,145 |
| Demonstration and loaner monitors. . | 1,485,663 | 1,407,587 |
| | 11,691,742 | 11,356,326 |
| Property, plant and equipment - cost | 11,691,742 | 11,356,326 |
| Less: accumulated depreciation. . . | 5,688,507 | 5,367,670 |
| | 6,003,235 | 5,988,656 |
| Property, plant and equipment - net. | \$ 6,003,235 | \$ 5,988,656 |

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CRITICARE SYSTEMS, INC.
Management's Discussion and Analysis of
Results of Operations and Financial Condition
Six Months Ended December 31, 2000 and 1999

RESULTS OF OPERATIONS

Sales revenue for the six months ended December 31, 2000 was \$700 thousand less than that of the same period in the prior year. Two significant, isolated sales in the prior year period, and the partial return of product from one of these sales in the current year period increased sales revenue for the prior year period and reduced sales revenue for the current year period. After adjusting for both, sales revenue is relatively comparable. In addition, the selling price of some of the Company's older product line have hurt overall revenue even though the number of units sold in the current year period was up 8% from the prior year period. OEM sales, which were minimal in the prior year period, accounted for an incremental \$1.5 million.

The gross profit percentage of 40% in the first six months of the current year is 6% below that of the same period in fiscal 2000. Margins fell throughout the prior year and rebounded to 40% in the first quarter of fiscal 2001, which is where they have remained. As the cost per unit has not changed dramatically, the decline is attributed to the lower sales prices on established products as discussed above, and introductory pricing on the Company's newly introduced products. As these newer products begin selling at prices that more closely approximate list price, the Company expects to see further improvement in its margins. See "Forward-Looking Statements."

To offset the drop in margins, the Company has had to continue to find ways to reduce operating expenses, and has done so with much success. Operating expenses for the current year period were over \$1 million less than that of the prior year period. Of this total, \$300 thousand was a reversal of previously recorded bad debt expense related to the sales return mentioned above; however, the remaining \$700 thousand relates to more tangible savings. Approximately \$300 thousand of this total is attributed to better controls over trade show expenses and a reduction of sales related salaries and commissions. The final \$400 thousand of the decrease was a result of a reduction in engineering project expense as there was a significant amount of activity in the first half of the prior year related to the development of the new products released in late fiscal 2000. The net \$1 million savings in operational expenses was enough to offset the reduction in margins, and leave a slight profit from operations for the current year period while the prior year period showed a loss.

Other income and expense for the current year period was 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 in which the Company still has a position. This gain essentially accounts for the difference in net income/(loss), as well.

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CRITICARE SYSTEMS, INC.
Management's Discussion and Analysis of
Results of Operations and Financial Condition
Three Months Ended December 31, 2000 and 1999

RESULTS OF OPERATIONS

As was the case in the first quarter of fiscal 2001, sales volume (number of

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units sold) for the three months ended December 31, 2000 exceeded the sales volume for the same period in fiscal 2000. And after adjusting for a \$300 thousand return of product, previously reserved for as an at risk receivable, sales revenue was at approximately the same level in the current year period as in the prior year period. Both the sales revenue level and gross margin were adversely affected by two major factors. The first was promotional pricing designed to accelerate the introduction of the new POET line of monitors, and the second was the heavily discounted sale of remaining obsolete products to avoid significant inventory write downs. As all of the promotional units have been cleared from the backlog, it is anticipated that future sales will be closer to list price, resulting in a rise in the third quarter margins. See "Forward-Looking Statements."

Operating expenses in the current year period decreased \$900 thousand from that of the prior year period, of which \$300 thousand was a reversal of previously recorded bad debt expense related to the sales return mentioned above. Another \$300 thousand of this decrease is attributed to improved expense control over trade shows and a reduction of sales related salaries and commissions. The final \$300 thousand of the decrease was a result of a reduction in engineering project expense.

The second quarter of fiscal 2001 was the first quarter in which the Company was able to generate income from operations (\$100 thousand) since the first quarter of fiscal 2000. These numbers reflected a nice turn around as compared to the three months ended December 31, 1999 when the same level of sales resulted in a loss from operations (\$200 thousand). If the level of operating expense can be maintained while improving margins, the Company expects that this number should also continue to improve. See "Forward-Looking Statements."

Non-operating expenses of approximately \$65 thousand (mortgage interest) in the current year period were partially offset by \$35 thousand of interest income on the private placement proceeds (see "Liquidity"). These amounts are comparable to those in the prior year period. However, the prior year period also included a \$740 thousand gain on the sale of Immtech stock, which accounted for the difference in the non-operating expense totals and turned the operating loss for the prior year period into a net profit.

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

LIQUIDITY

As of December 31, 2000, the Company had a cash balance of approximately \$3.5 million and no short-term borrowings. In the preceding six months, approximately \$360 thousand was used in operations, and another \$260 thousand was invested in property, plant and equipment. In October 2000, the Company received \$4.0 million in proceeds from the private placement of additional shares of the Company's own common stock. The primary intended use of these funds is for additional research and development and an expanded marketing program. In the prior year, approximately \$2.5 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 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

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December 31, 2000, 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, and competition in the Company's markets.

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Item 2. Changes in Securities and Use of Proceeds

(c) On October 17, 2000, the Company issued 1,786,273 shares of common stock to Oxford Bioscience Partners III, L.P., Oxford Bioscience Partners (Bermuda) III Limited Partnership and mRNA Fund L.P. at a price of \$2.25 per share. These shares were issued in a private placement exempt from the registration requirements of the Securities Act of 1933, as amended (the "Act") pursuant to Section 4(2) of the Act.

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

The annual meeting of stockholders of the Company was held on December 1, 2000. The matters voted upon, including the number of votes cast for, against or withheld, as well as the number of abstentions and broker non-votes, as to each such matter were as follows:

Proposal 1: Election of directors for a term ending at the 2003 annual meeting of stockholders.

| | For | Withheld |
|---------------|-----------|----------|
| | --- | ----- |
| Karsten Houm | 6,273,535 | 750,827 |
| Emil H. Soika | 6,339,512 | 684,850 |

The Company's other directors consist of Milton Datsopoulos and Higgins D. Bailey (whose terms end at the 2001 annual meeting of stockholders) and N.C. Joseph Lai and Jeffrey T. Barnes (whose terms end at the 2002 annual meeting of stockholders).

Proposal 2: Approval of the Amendment to the Criticare Systems, Inc. 1992 Employee Stock Option Plan to increase the number of authorized shares under the Plan from 1,540,000 to 2,040,000.

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| For | Against | Abstain | Broker Non-Votes |
|-----------|-----------|---------|------------------|
| --- | ----- | ----- | ----- |
| 1,818,204 | 1,045,207 | 115,280 | 4,045,671 |

Proposal 3: Ratification of appointment of BDO Seidman, LLP as auditors of the Company.

| For | Against | Abstain | Broker Non-Votes |
|-----------|---------|---------|------------------|
| --- | ----- | ----- | ----- |
| 6,863,464 | 147,173 | 13,725 | 0 |

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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).
- 10.1 Purchase Agreement, dated as of October 17, 2000, among the Company, Oxford Bioscience Partners III L.P., Oxford Bioscience Partners (Bermuda) III Limited Partnership and mRNA Fund L.P. (incorporated by reference to the Registration Statement filed on Form S-1, Registration No. 333-50884).

(b) Reports on Form 8-K. None during the quarter ended December 31, 2000.

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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: February 9, 2001

BY /s/ Mark S. Ruehle

Mark S. Ruehle
Vice President - Finance
(Chief Accounting Officer and

Duly Authorized Officer)