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CRITICARE SYSTEMS INC /DE/
Form 10-Q
November 14, 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 September 30, 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 September 30, 2001: Class A Common Stock 10,796,224 shares.

CRITICARE SYSTEMS, INC.

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CONSOLIDATED BALANCE SHEETS
SEPTEMBER 30, 2001 AND JUNE 30, 2001

(UNAUDITED)

| | September 30, 2001 | June 30, 2001 |
|---|-----------------------|------------------|
| | ----- | ----- |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 1,477,696 | \$ 3,362,100 |
| Accounts receivable, less allowance for doubtful accounts of \$1,075,000 and \$1,000,000, respectively | 6,248,352 | 7,122,466 |
| Investments | 2,464,420 | 3,970,451 |
| Other receivables | 32,451 | 33,788 |
| Inventories | 8,998,080 | 8,600,411 |
| Prepaid expenses | 454,764 | 502,177 |
| | ----- | ----- |
| Total current assets | 19,675,763 | 23,591,393 |
| Property, plant and equipment - net | 6,289,716 | 6,182,477 |
| License rights and patents - net | 96,238 | 97,988 |
| | ----- | ----- |
| TOTAL | \$ 26,061,717 | \$29,871,856 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 2,474,783 | \$ 3,421,777 |
| Accrued liabilities: | | |
| Compensation and commissions | 914,234 | 1,196,499 |
| Product warranties | 230,000 | 220,000 |
| Accrued taxes other than income | 107,976 | 96,944 |
| Accrued royalty | 96,871 | 68,351 |
| Accrued audit and legal fees | 36,998 | 35,900 |
| Other | 437,249 | 469,677 |
| Current maturities of long-term debt | 88,430 | 86,766 |
| | ----- | ----- |
| Total current liabilities | 4,386,541 | 5,595,900 |
| LONG-TERM DEBT, less current maturities | 3,174,887 | 3,197,121 |
| OTHER LONG-TERM OBLIGATIONS | 57,171 | 73,000 |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock | - | - |
| Common stock - \$.04 par value, 15,000,000 shares authorized, 10,796,224 shares issued and outstanding | 431,849 | 431,849 |
| Additional paid-in capital | 22,497,058 | 22,494,541 |
| Common stock held in treasury (62,706 and 64,134 shares, respectively) | (116,806) | (119,466) |
| Retained earnings (accumulated deficit) | (6,833,403) | (5,771,566) |
| Accumulated comprehensive income | 2,464,420 | 3,970,451 |
| | ----- | ----- |
| Total stockholders' equity | 18,443,118 | 21,005,815 |

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| | | |
|-----------------|---------------|-------------|
| TOTAL | \$ 26,061,717 | \$29,871,85 |
| | ===== | ===== |

See notes to consolidated financial statements.

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CRITICARE SYSTEMS, INC.
CONSOLIDATED INCOME STATEMENTS
THREE MONTHS ENDED SEPTEMBER 30, 2001 AND 2000

(UNAUDITED)

| | 2001 | 2000 |
|--|----------------|--------------|
| | ----- | ----- |
| NET SALES | \$ 5,489,137 | \$6,229,877 |
| COST OF GOODS SOLD | 3,677,701 | 3,718,831 |
| | ----- | ----- |
| GROSS PROFIT | 1,811,436 | 2,511,046 |
| OPERATING EXPENSES: | | |
| Marketing | 1,600,355 | 1,475,109 |
| Research, development and engineering | 587,083 | 581,282 |
| Administrative | 660,778 | 562,238 |
| | ----- | ----- |
| Total | 2,848,216 | 2,618,629 |
| (LOSS) FROM OPERATIONS | (1,036,780) | (107,583) |
| OTHER INCOME (EXPENSE): | | |
| Interest expense | (62,676) | (64,806) |
| Interest income | 33,044 | 6,419 |
| Other income/(expense) | 4,577 | - |
| | ----- | ----- |
| Total | (25,055) | (58,387) |
| (LOSS) BEFORE INCOME TAXES | (1,061,835) | (165,970) |
| INCOME TAX PROVISION | - | - |
| | ----- | ----- |
| NET (LOSS) | \$ (1,061,835) | \$ (165,970) |
| | ===== | ===== |
| NET (LOSS) PER COMMON SHARE | | |
| Basic | \$ (0.10) | \$ (0.02) |
| Diluted | \$ (0.10) | \$ (0.02) |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 10,733,029 | 8,898,607 |
| Diluted | 10,733,029 | 8,898,607 |

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See notes to consolidated financial statements.

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CRITICARE SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED SEPTEMBER 30, 2001 AND 2000

(UNAUDITED)

| | 2001 | 2000 |
|--|----------------|--------------|
| | ----- | ----- |
| OPERATING ACTIVITIES: | | |
| Net (loss) | \$ (1,061,835) | \$ (165,970) |
| Adjustments to reconcile net (loss) to net cash (used in) provided by operating activities: | | |
| Depreciation | 246,045 | 127,499 |
| Amortization | 1,751 | 3,600 |
| Provision for doubtful accounts | 75,000 | 100,000 |
| Changes in assets and liabilities: | | |
| Accounts receivable | 799,112 | 231,108 |
| Other receivables | 1,337 | (7,130) |
| Inventories | (660,432) | 430,907 |
| Prepaid expenses | 47,408 | (271,628) |
| Accounts payable | (946,993) | (249,210) |
| Accrued liabilities | (279,871) | (4,967) |
| | ----- | ----- |
| Net cash (used in) provided by operating activities . | (1,778,478) | 194,209 |
| INVESTING ACTIVITIES: | | |
| Purchases of property, plant and equipment, net . . . | (90,526) | (116,434) |
| | ----- | ----- |
| Net cash (used in) provided by investing activities . | (90,526) | (116,434) |
| FINANCING ACTIVITIES: | | |
| Principal payments on long-term debt | (20,575) | (19,023) |
| Proceeds from issuance of common stock | 5,171 | 39,258 |
| | ----- | ----- |
| Net cash provided by (used in) financing activities . | (15,404) | 20,235 |
| NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS. | (1,884,408) | 98,010 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 3,362,104 | 114,830 |
| | ----- | ----- |
| CASH AND CASH EQUIVALENTS, END OF YEAR | \$ 1,477,696 | \$ 212,840 |
| | ===== | ===== |

See notes to consolidated financial statements.

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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 statements and notes thereto included in the Company's latest annual report and previously filed Form 10-K. Certain amounts from the fiscal 2001 financial statements have been reclassified to conform to the 2002 presentation.

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 September 30, 2001 and June 30, 2001, respectively:

| | September 30, 2001 | June 30, 2001 |
|--------------------------------|--------------------|---------------|
| | ----- | ----- |
| Component parts | \$ 3,955,229 | \$ 3,784,491 |
| Work in process | 1,598,046 | 1,372,587 |
| Finished units | 3,811,099 | 3,768,335 |
| | ----- | ----- |
| Total inventories | 9,364,374 | 8,925,413 |
| Less: reserve for obsolescence | 366,294 | 325,000 |
| | ----- | ----- |
| Net inventory | \$ 8,998,080 | \$ 8,600,413 |

3. INVESTMENTS

The Company held 456,374 shares of Immtech International, Inc. ("Immtech") stock, which was trading at \$5.40 per share, on September 28, 2001. The market value of these shares could change substantially due to overall market risk.

The Company entered into an agreement with Immtech dated November 2, 2001 in order to have the restricted legends removed from the Immtech stock certificates. Under the agreement, portions of the Company's Immtech stock will be subject to restrictions on transfer for relatively short-term periods of up to six months, after which time all such stock will be free of restrictions.

4. PROPERTY, PLANT AND EQUIPMENT

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Property, plant and equipment consist of the following:

| | September 30, 2001 | June 30, 2001 |
|--------------------------------------|--------------------|---------------|
| | ----- | ----- |
| Land and building. | \$ 4,525,000 | \$ 4,525,000 |
| Machinery and equipment. | 2,009,480 | 2,055,518 |
| Furniture and fixtures | 812,931 | 837,238 |
| Demonstration and loaner monitors. . | 1,726,674 | 1,463,909 |
| Production tooling | 3,201,683 | 3,122,938 |
| | ----- | ----- |
| Property, plant and equipment - cost | 12,275,768 | 12,004,603 |
| Less: accumulated depreciation. . . | 5,986,052 | 5,822,133 |
| | ----- | ----- |
| Property, plant and equipment - net. | \$ 6,289,716 | \$ 6,182,470 |

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CRITICARE SYSTEMS, INC.
Management's Discussion and Analysis of
Results of Operations and Financial Condition
Three Months Ended September 30, 2001 and 2000

RESULTS OF OPERATIONS

Net sales for the three months ended September 30, 2001 decreased 12% from the same period in fiscal 2000. The sales reduction was driven by a 10% shortfall in the number of units sold and a 2-4% decrease in the average sales price per unit from the prior year of products contributing the majority of the revenue for the quarter. The decrease in sales volume can be attributed to a combination of the slowing economy and the events of September 11th, which basically eliminated sales from one of the Company's largest domestic trade shows that was held that week. In each of the last two fiscal years this trade show has generated up to 5% of the Company's total annual revenue, the majority being contributed in the first and second fiscal quarters. In addition, international sales that historically represent approximately 40% of total Company sales were down in the first quarter from the same period in the prior year. On a positive note, OEM sales continued to be a significant distribution channel for the Company for the three months ended September 30, 2001, increasing 22% from the same period the prior year and contributing 21% to overall Company sales. This trend towards higher OEM sales is expected to continue for the remainder of fiscal 2002 and future years. See "Forward-Looking Statements."

Pricing pressures, combined with higher manufacturing costs to support the Company's efforts to transition its manufacturing offshore, were the major contributors to the lower gross profit percentage of 33% generated in the first quarter of the current year. The gross profit percentage was down seven percentage points from the 40% gross profit percentage that was generated in the first quarter of the prior year. In addition to the lower sales prices for monitors discussed above, margins on accessory sales declined 4 percentage points in the current quarter from the prior year. The Company expects to complete its outsourcing plan by the end of calendar year 2001 and to see improved margins for the last two quarters of fiscal 2002 as it begins to realize lower product costs from its foreign manufacturers. See "Forward-Looking Statements."

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Operating expenses increased \$229,587 for the three months ended September 30, 2001 compared to the prior year due to higher marketing and administrative spending. Marketing expenses increased \$125,246 mainly due to higher contract labor costs and operating supply spending for warranty repairs and paid service work. Administrative expenses increased \$98,540 due mostly to higher accounting and consulting fees and legal expenses related to various corporate matters.

The lower sales and the decrease in gross profit performance for the three months ended September 30, 2001, combined with the higher operating expenses, resulted in a net loss before taxes of \$1,061,835 which was \$895,865 greater than the \$165,970 loss generated for the same period in the prior year. The Company expects profitability to improve significantly in the last three quarters of fiscal 2002 from the results generated in the first quarter, driven by higher sales, stronger margins as it begins to realize the cost savings from its outsourced manufacturing plan, and lower operating expenses. See "Forward-Looking Statements."

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LIQUIDITY

As of September 30, 2001, the Company had a cash balance of \$1,477,696, which was down from a balance of \$3,362,104 at June 30, 2001, and no short-term borrowings. \$1,778,478 of the \$1,884,408 reduction in cash in the quarter was used to support operating activities, while another \$90,526 was invested in property, plant, and equipment and \$20,575 was used to pay down long term debt. The decrease in the Company's cash position in the fiscal first quarter was primarily a timing issue as strong cash collections in the first month of the fiscal second quarter have increased the Company's cash and cash equivalents balance to approximately \$2.6 million in early November. The favorable cash inflow in October 2001 was driven mainly by payments of receivables for sales made in June 2001 with extended payment terms. The Company believes all capital and liquidity requirements for the remainder of fiscal 2002 will be satisfied by cash generated from operations and periodic utilization of a \$4,000,000 line of credit currently in place, if necessary. At September 30, 2001, there were no borrowings outstanding under this line of credit. The line of credit expires in November 2002.

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, competition in the Company's markets,

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unanticipated difficulties in outsourcing 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 the Company's ability to reduce costs by eliminating excess capacity at its principal facility.

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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).
- 4.2 Rights Agreement (incorporated by reference to the Company's Current Report on Form 8-K filed on April 18, 1997).

(b) Reports on Form 8-K: None in the quarter ended September 30, 2001.

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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: November 14, 2001

BY /s/ Michael J. Sallmann

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

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