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CRITICARE SYSTEMS INC /DE/
Form 10-Q
February 07, 2002

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, 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 December 31, 2001: Common Stock 10,965,724 shares.

CRITICARE SYSTEMS, INC.

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CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2001 AND JUNE 30, 2001

(UNAUDITED)

| ASSETS | December 31, 2001 | June 30 2001 |
|--|----------------------|-----------------|
| | ----- | ----- |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 3,457,158 | \$ 3,362,1 |
| Accounts receivable, less allowance for doubtful accounts of \$1,000,000, respectively | 5,506,403 | 7,122,4 |
| Investments | 2,395,964 | 3,970,4 |
| Other receivables | 18,447 | 33,7 |
| Inventories | 8,095,472 | 8,600,4 |
| Prepaid expenses | 372,305 | 502,1 |
| | ----- | ----- |
| Total current assets | 19,845,749 | 23,591,3 |
| Property, plant and equipment - net | 6,121,709 | 6,182,4 |
| License rights and patents - net | 94,488 | 97,9 |
| | ----- | ----- |
| TOTAL | \$ 26,061,946 | \$29,871,8 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable | \$ 2,060,147 | \$ 3,421,7 |
| Accrued liabilities: | | |
| Compensation and commissions | 901,197 | 1,187,4 |
| Product warranties | 230,000 | 220,0 |
| Accrued taxes other than income | 126,440 | 96,9 |
| Accrued contract costs | 267,662 | 207,0 |
| Other | 270,472 | 375,8 |
| Current maturities of long-term debt | 90,117 | 86,7 |
| | ----- | ----- |
| Total current liabilities | 3,946,035 | 5,595,9 |
| LONG-TERM DEBT, less current maturities | 3,151,552 | 3,197,1 |
| OTHER LONG-TERM OBLIGATIONS | 53,823 | 73,0 |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock | - | |
| Common stock - \$.04 par value, 15,000,000 shares authorized, 10,965,724 and 10,796,224 shares issued, respectively | 438,629 | 431,8 |
| Additional paid-in capital | 22,838,643 | 22,494,5 |
| Common stock held in treasury (61,634 and 64,134 shares, respectively) | (114,810) | (119,4 |
| Retained earnings (accumulated deficit) | (6,647,890) | (5,771,5 |
| Accumulated comprehensive income | 2,395,964 | 3,970,4 |
| | ----- | ----- |
| Total stockholders' equity | 18,910,536 | 21,005,8 |
| | ----- | ----- |
| TOTAL | \$ 26,061,946 | \$29,871,8 |
| | ===== | ===== |

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See notes to consolidated financial statements.

2

CRITICARE SYSTEMS, INC.
CONSOLIDATED INCOME STATEMENTS
SIX MONTHS ENDED DECEMBER 31, 2001 AND 2000

(UNAUDITED)

| | 2001 | 2000 |
|--|--------------|--------------|
| | ----- | ----- |
| NET SALES | \$12,835,733 | \$12,794,000 |
| COST OF GOODS SOLD. | 8,160,154 | 7,702,405 |
| | ----- | ----- |
| GROSS PROFIT. | 4,675,579 | 5,091,595 |
| OPERATING EXPENSES: | | |
| Marketing | 3,103,433 | 2,804,151 |
| Research, development and engineering | 1,167,701 | 1,132,282 |
| Administrative. | 1,243,596 | 1,129,201 |
| | ----- | ----- |
| Total | 5,514,730 | 5,065,634 |
| (LOSS) INCOME FROM OPERATIONS | (839,151) | 25,961 |
| OTHER INCOME (EXPENSE): | | |
| Interest expense. | (124,947) | (128,669) |
| Interest income | 47,999 | 42,396 |
| Other | 39,777 | - |
| | ----- | ----- |
| Total | (37,171) | (86,273) |
| LOSS BEFORE INCOME TAXES. | (876,322) | (60,312) |
| INCOME TAX PROVISION. | - | - |
| | ----- | ----- |
| NET LOSS. | \$ (876,322) | \$ (60,312) |
| | ===== | ===== |
| NET LOSS PER COMMON SHARE: | | |
| Basic | \$ (0.08) | \$ (0.01) |
| Diluted | \$ (0.08) | \$ (0.01) |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 10,761,035 | 9,636,284 |
| Diluted | 10,761,035 | 9,636,284 |

See notes to consolidated financial statements.

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3

CRITICARE SYSTEMS, INC.
CONSOLIDATED INCOME STATEMENTS
THREE MONTHS ENDED DECEMBER 31, 2001 AND 2000

(UNAUDITED)

| | 2001 | 2000 |
|--|--------------|--------------|
| | ----- | ----- |
| NET SALES | \$ 7,346,596 | \$ 6,564,123 |
| COST OF GOODS SOLD. | 4,482,453 | 3,983,575 |
| | ----- | ----- |
| GROSS PROFIT. | 2,864,143 | 2,580,548 |
| OPERATING EXPENSES: | | |
| Marketing | 1,503,078 | 1,329,042 |
| Research, development and engineering | 580,618 | 551,000 |
| Administrative. | 582,818 | 566,963 |
| | ----- | ----- |
| Total | 2,666,514 | 2,447,005 |
| INCOME FROM OPERATIONS. | 197,629 | 133,543 |
| OTHER INCOME (EXPENSE): | | |
| Interest expense. | (62,271) | (63,862) |
| Interest income | 14,954 | 35,977 |
| Other | 35,201 | - |
| | ----- | ----- |
| Total | (12,116) | (27,885) |
| INCOME BEFORE INCOME TAXES | 185,513 | 105,658 |
| INCOME TAX PROVISION. | - | - |
| | ----- | ----- |
| NET INCOME. | \$ 185,513 | \$ 105,658 |
| | ===== | ===== |
| NET INCOME PER COMMON SHARE: | | |
| Basic | \$ 0.02 | \$ 0.01 |
| Diluted | \$ 0.02 | \$ 0.01 |
| WEIGHTED AVERAGE NUMBER OF COMMON SHARES OUTSTANDING: | | |
| Basic | 10,789,041 | 10,373,962 |
| Diluted | 11,499,734 | 10,517,441 |

See notes to consolidated financial statements.

4

CRITICARE SYSTEMS, INC.

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CONSOLIDATED STATEMENTS OF CASH FLOWS
SIX MONTHS ENDED DECEMBER 31, 2001 AND 2000

(UNAUDITED)

| | 2001 | 2000 |
|--|--------------|-------------|
| | ----- | ----- |
| OPERATING ACTIVITIES: | | |
| Net loss | \$ (876,322) | \$ (60,312) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation | 389,675 | 320,837 |
| Amortization | 3,501 | 8,100 |
| Provision for doubtful accounts | - | (200,000) |
| Changes in assets and liabilities: | | |
| Accounts receivable | 1,616,061 | 67,346 |
| Other receivables | 15,341 | 18,126 |
| Inventories | 323,847 | 306,044 |
| Prepaid expenses | 129,867 | (238,658) |
| Accounts payable | (1,361,629) | (267,575) |
| Accrued liabilities | (310,776) | (313,219) |
| | ----- | ----- |
| Net cash used in operating activities | (70,435) | (359,311) |
| INVESTING ACTIVITIES: | | |
| Purchases of property, plant and equipment, net | (147,820) | (257,340) |
| | ----- | ----- |
| Net cash used in investing activities | (147,820) | (257,340) |
| FINANCING ACTIVITIES: | | |
| Principal payments on long-term debt | (42,223) | (39,107) |
| Proceeds from issuance of common stock | 355,532 | 4,068,385 |
| | ----- | ----- |
| Net cash provided by financing activities | 313,309 | 4,029,278 |
| NET INCREASE IN CASH AND CASH EQUIVALENTS | 95,054 | 3,412,627 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD. | 3,362,104 | 114,830 |
| | ----- | ----- |
| CASH AND CASH EQUIVALENTS, END OF PERIOD. | \$ 3,457,158 | \$3,527,457 |
| | ===== | ===== |

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

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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 December 31 and June 30, 2001, respectively:

| | December 31, 2001 | June 30, 2001 |
|--------------------------------|-------------------|---------------|
| | ----- | ----- |
| Component parts | \$ 3,567,160 | \$ 3,784,491 |
| Work in process | 1,257,185 | 1,372,587 |
| Finished units | 3,660,263 | 3,768,335 |
| | ----- | ----- |
| Total inventories | 8,484,608 | 8,925,413 |
| Less: reserve for obsolescence | 389,136 | 325,000 |
| | ----- | ----- |
| Net inventory | \$ 8,095,472 | \$ 8,600,413 |

3. INVESTMENTS

The Company held 456,374 shares of Immtech stock, which was trading at \$5.25 per share, on December 31, 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

Property, plant and equipment consist of the following:

| | December 31, 2001 | June 30, 2001 |
|---------------------------------------|-------------------|---------------|
| | ----- | ----- |
| Land and building | \$ 4,525,000 | \$ 4,525,000 |
| Machinery and equipment | 2,027,189 | 2,055,518 |
| Furniture and fixtures | 813,247 | 837,238 |
| Demonstration and loaner monitors . . | 1,645,003 | 1,463,909 |
| Production tooling | 3,229,316 | 3,122,938 |

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| | | |
|---|------------|--------------|
| | ----- | ----- |
| Property, plant and equipment - cost | 12,239,755 | 12,004,603 |
| Less: accumulated depreciation. . . | 6,118,046 | 5,822,133 |
| | ----- | ----- |
| Property, plant and equipment - net. \$ | 6,121,709 | \$ 6,182,470 |

7

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

RESULTS OF OPERATIONS

Strong net sales in the fiscal second quarter ended December 31, 2001 increased year-to-date sales for the six months ended December 31, 2001 slightly above prior year. A 3% increase in the number of units shipped and an 18% increase in accessory sales basically offset an 8% decrease in the average selling price per unit that was mainly driven by a reduction in unit sales of the Company's higher end monitors. The continued growth in OEM sales, which were up 19% for the six months ended December 31, 2001 from the same period in the prior year, offset a 7% decrease in domestic sales. The events of September 11th virtually eliminated sales from one of the Company's largest domestic trade shows that took place that week and was the main reason for the lower domestic sales for the six months ended December 31, 2001 from the same period in the prior year.

The gross profit percentage for the first six months of the current year improved to 36.4% from the 33.0% generated in the fiscal first quarter of the current year, but was still down from the 39.8% realized for the first six months of the prior year. Higher manufacturing costs in the first six months of the current year to support the Company's efforts to transition its manufacturing offshore during this period was the major contributor to the lower margin between years. The Company has completed its outsourcing plan at the end of calendar year 2001 and expects 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."

Operating expenses for the six months ended December 31, 2001 were higher than the same period in the prior year by \$449,096. However, operating expenses in the fiscal second quarter of the prior year included the release of previously recorded specific bad debt reserve of \$335,000 and the reversal of previously recorded commission expense of \$37,000. The release of the specific reserve for bad debts related to the repossession of product from a foreign distributor that had been reserved for as an at risk receivable in a prior period. The reversal of commission expense related to commissions accrued in a prior period for salespeople that left the Company prior to payment being received from the customer. Excluding the impact of these expense reversals from the prior period, operating expenses for the six months ended December 31, 2001 were actually up only \$77,096, or 1.4%, from the same period in the prior year.

The reduction in gross profit performance and the higher operating expenses resulted in the recognition of a loss of \$876,322 for the six months ended December 31, 2001, compared to the loss of \$60,312 for the same period in the prior year. The Company expects to continue to improve profitability in the last half of fiscal 2002 through higher sales, stronger margins, and reduced operating expenses compared to the results generated in the first half of fiscal 2002. See "Forward-Looking Statements."

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

RESULTS OF OPERATIONS

Net sales for the three months ended December 31, 2001 increased 12% from the same period in the prior year, driven by a 13% increase in the number of units shipped in the current quarter. Higher international shipments and the continued growth of OEM business in the quarter more than offset domestic sales that were basically flat between periods. As noted above, the events of September 11th virtually eliminated sales from one of the Company's largest domestic trade shows and was the major reason for the lack of growth in domestic sales in the current quarter from the prior year.

The gross profit percentage of 39.0% for the three months ended December 31, 2001 rebounded significantly from the 33.0% produced in the fiscal first quarter of the current year and was basically level to the 39.3% generated for the three months ended December 31, 2000. Excluding the impact of sales of excess and slow moving inventory sold at cost of \$127,000 from the current period, the gross profit percentage would improve to 39.7% for the three months ended December 31, 2001.

Operating expenses in the current year period increased \$219,509 from the same period in the prior year. However, as noted above, expenses in the second quarter of fiscal 2001 included the reversal of expenses recognized in prior periods totaling \$372,000. Excluding the impact of these expense reversals from the prior year fiscal second quarter results, operating expenses for the three months ended December 31, 2001 were actually down \$152,491, or 5.4%, from the same period in the prior year.

Income from operations of \$197,629 for the three months ended December 31, 2001 increased \$64,086 from the prior year and represented its highest level in four years since the second quarter of fiscal 1998. A \$15,769 reduction in other expenses in the current year period resulted in net income of \$185,513 that was \$79,855 higher than the same period in the prior year.

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

LIQUIDITY

As of December 31, 2001, the Company had a cash balance of \$3,457,158 and no short-term borrowings. The cash position was up almost \$2.0 million from its level at September 30, 2001 and is \$95,054 higher than the balance at June 30, 2001 of \$3,362,104, primarily due to strong cash collections in the fiscal second quarter of the current year. For the six months ended December 31, 2001, \$70,435 of cash was used to support operating activities and \$147,820 was invested in property, plant, and equipment. These uses of cash were funded by \$355,532 in proceeds received from the issuance of common stock related to the

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exercise of stock options in the fiscal second quarter.

The Company believes all capital and liquidity requirements for the remainder of fiscal 2002 will be satisfied by cash generated from operations and its current cash balances. The Company also has a \$4,000,000 line of credit currently in place that expires in November 2003 that could be utilized, if necessary. At December 31, 2001, there were no borrowings outstanding under this 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, competition in the Company's markets, 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.

PART II - OTHER INFORMATION

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

The annual meeting of stockholders of the Company was held on November 30, 2001. 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 2004 annual meeting of stockholders.

| | For | Withheld |
|-----------------------|-----------|----------|
| | --- | ----- |
| Milton Datsopoulos . | 9,555,913 | 107,227 |
| Dr. Higgins D. Bailey | 9,553,013 | 110,127 |

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The Company's other directors consist of N.C. Joseph Lai and Jeffrey T. Barnes (whose terms end at the 2002 annual meeting of stockholders) and Karsten Houm, Emil H. Soika and Stephen K. Tannenbaum (whose terms end at the 2003 annual meeting of stockholders).

Proposal 2: Ratification of appointment of BDO Seidman, LLP as auditors of the Company.

| For | Against | Abstain | Broker Non-Votes |
|-----------|---------|---------|------------------|
| ----- | ----- | ----- | ----- |
| 9,562,395 | 88,380 | 12,365 | 0 |

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).
- 10.1 Settlement Agreement, dated as of November 2, 2001, between the Company and Immtech International, Inc.

(b) Reports on Form 8-K: None in the quarter ended December 31, 2001.

11

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 7, 2002

BY /s/ Michael J. Sallmann

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

