SYNBIOTICS CORP
Form 10-Q
November 08, 2002
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U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2002

OR

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d)**
OF THE SECURITIES EXCHANGE ACT OF 1934
Commission file number 0-11303

SYNBIOTICS CORPORATION

(Exact name of registrant as specified in its charter)

California	**95-3737816**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
11011 Via Frontera **San Diego, California**	**92127**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (858) 451-3771

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 o

As of November 8, 2002, 17,953,514 shares of common stock were outstanding.

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SYNBIOTICS CORPORATION

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Synbiotics Corporation
Condensed Consolidated Balance Sheet

	September 30, 2002	December 31, 2001
	(unaudited)	(audited)
Assets		
Current assets:		
Cash and equivalents	$ 1,324,000	$ 1,039,000
Accounts receivable	2,342,000	2,983,000
Inventories	5,981,000	5,059,000
Other current assets	915,000	796,000
	10,562,000	9,877,000
Property and equipment, net	1,400,000	1,648,000
Goodwill	4,275,000	12,074,000
Intangibles, net	2,712,000	2,744,000
Deferred debt issuance costs		7,000
Other assets	530,000	152,000
	$ 19,479,000	$ 26,502,000
Liabilities and Shareholders Equity:		
Current Liabilities:		
Accounts payable and accrued expenses	$ 5,205,000	$ 5,915,000
Current portion of long-term debt	1,400,000	1,200,000
Deferred revenue	75,000	300,000
	6,680,000	7,415,000
Long-term debt	4,922,000	6,032,000
Other liabilities	1,920,000	1,804,000
	6,842,000	7,836,000
Mandatorily redeemable stock	2,604,000	3,107,000
Non-mandatorily redeemable common stock and other shareholders equity:		
Common stock, no par value, 70,000,000 shares authorized, 17,954,000 and 8,990,000 shares issued and outstanding at September 30, 2002 and December 31, 2001	46,050,000	40,286,000
Common stock warrants	1,035,000	1,035,000
Accumulated other comprehensive loss	(1,200,000)	(1,411,000)
Accumulated deficit	(42,532,000)	(31,766,000)

Total non-mandatorily redeemable common stock and other shareholders equity	3,353,000	8,144,000
	$ 19,479,000	$ 26,502,000

See accompanying notes to condensed consolidated financial statements.

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Item 1. Financial Statements (continued)

Synbiotics Corporation
Condensed Consolidated Statement of Operations and Comprehensive (Loss) Income (unaudited)

	Three Months Ended September 30, 2002	Three Months Ended September 30, 2001	Nine Months Ended September 30, 2002	Nine Months Ended September 30, 2001
Revenues:				
Net sales	$ 4,465,000	$ 5,835,000	$ 16,964,000	$ 20,546,000
License fees	75,000		225,000	969,000
Royalties	1,000	1,000	6,000	5,000
	4,541,000	5,836,000	17,195,000	21,520,000
Operating expenses:				
Cost of sales	2,069,000	2,411,000	7,469,000	8,519,000
Research and development	354,000	434,000	1,044,000	1,222,000
Selling and marketing	1,141,000	1,531,000	3,951,000	4,555,000
General and administrative	1,556,000	1,483,000	7,412,000	4,630,000
	5,120,000	5,859,000	19,876,000	18,926,000
(Loss) Income from operations	(579,000)	(23,000)	(2,681,000)	2,594,000
Other income (expense):				
Interest, net	(165,000)	(217,000)	(522,000)	(744,000)
(Loss) income before income taxes	(744,000)	(240,000)	(3,203,000)	1,850,000
(Benefit from) provision for income taxes	(111,000)	(34,000)	175,000	29,000
(Loss) income from continuing operations	(633,000)	(206,000)	(3,378,000)	1,821,000
Discontinued operations, net of tax	340,000	(10,000)	261,000	(97,000)
(Loss) income before cumulative effect of a change in accounting principle	(293,000)	(216,000)	(3,117,000)	1,724,000
Cumulative effect of a change in accounting principle, net of tax			(7,649,000)	
Net (loss) income	(293,000)	(216,000)	(10,766,000)	1,724,000
Translation adjustment	(96,000)	405,000	211,000	(166,000)
Comprehensive income (loss)	$ (389,000)	$ 189,000	$ (10,555,000)	$ 1,558,000
Basic and diluted (loss) income per share:				
(Loss) income from continuing operations	(0.04)	(0.02)	(0.26)	0.18
Discontinued operations, net of tax	0.02		0.02	(0.01)
			(0.56)	

Cumulative effect of a change in accounting principle, net of tax				
Net (loss) income	$ (0.02)	$ (0.02)	$ (0.80)	$ 0.17

See accompanying notes to condensed consolidated financial statements.

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Item 1. Financial Statements (continued)

Synbiotics Corporation
Condensed Consolidated Statement of Cash Flows (unaudited)

	Nine Months Ended September 30,	
	2002	2001
Cash flows from operating activities:		
Net (loss) income	$ (10,766,000)	$ 1,724,000
Adjustments to reconcile net (loss) income to net cash (used for) provided by operating activities:		
Depreciation and amortization	770,000	1,716,000
Retention bonus payable in common stock	2,641,000	
Legal settlement payable in common stock	15,000	
Note receivable for discontinued operations	(500,000)	
Cumulative effect of a change in accounting principle	7,756,000	
Changes in assets and liabilities (net of acquisitions and dispositions):		
Accounts receivable	824,000	444,000
Inventories	(765,000)	(103,000)
Deferred taxes		(8,000)
Other assets	(221,000)	(150,000)
Accounts payable and accrued expenses	(1,064,000)	(753,000)
Deferred revenue	(225,000)	(969,000)
Other liabilities	112,000	(597,000)
Net cash (used for) provided by operating activities	(1,423,000)	1,304,000
Cash flows from investing activities:		
Acquisition of property and equipment	(29,000)	(219,000)
Proceeds from sale of investment in W3 held for sale		9,000
Net cash used for investing activities	(29,000)	(210,000)
Cash flows from financing activities:		
Payments of long-term debt	(910,000)	(900,000)
Proceeds from issuance of mandatorily redeemable preferred stock, net	2,604,000	
Net cash provided by (used for) financing activities	1,694,000	(900,000)
Net increase in cash and equivalents	242,000	194,000
Effect of exchange rates on cash	43,000	(12,000)
Cash and equivalents beginning of period	1,039,000	951,000
Cash and equivalents end of period	$ 1,324,000	$ 1,133,000

See accompanying notes to condensed consolidated financial statements.

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Item 1. Financial Statements (continued)

SYNBIOTICS CORPORATION
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 1 - Interim Financial Statements:

The accompanying condensed consolidated balance sheet as of September 30, 2002 and the condensed consolidated statements of operations and comprehensive (loss) income and of cash flows for the three and nine months ended September 30, 2002 and 2001 have been prepared by Synbiotics Corporation (the Company) and have not been audited. The condensed consolidated financial statements of the Company include the accounts of its wholly-owned subsidiary Synbiotics Europe SAS (SBIO-E). All significant intercompany transactions and accounts have been eliminated in consolidation. These financial statements, in the opinion of management, include all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the financial position, results of operations and cash flows for all periods presented. The financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K filed for the year ended December 31, 2001. Interim operating results are not necessarily indicative of operating results for the full year.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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 those estimates.

Note 2 - New Accounting Pronouncements

As of January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142 (FAS 142), Goodwill and Other Intangible Assets . FAS 142 changed the accounting for goodwill from an amortization method to an impairment-only approach. Under FAS 142, goodwill is tested annually and whenever events or circumstances occur indicating that goodwill might be impaired. Upon adoption of FAS 142, amortization of goodwill recorded for business combinations consummated prior to July 1, 2001 ceased. In connection with the adoption of FAS 142, the Company performed a transitional goodwill impairment assessment. As a result of this impairment assessment, in the first quarter of 2002 the Company recorded an impairment of $7,649,000, net of income tax benefit of $106,000, which is classified as a cumulative effect of a change in accounting principle for the nine months ended September 30, 2002. Subsequent impairment assessments will be performed, at a minimum, in the fourth quarter of each year; and subsequent impairments, if any, will be classified as an operating expense. The Company s measurement of fair value was based upon a fairness opinion prepared by an independent investment advisor in conjunction with the Redwood transaction (Note 3).

As of January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 144 Accounting for the Impairment or Disposal of Long-Lived Assets (FAS 144). FAS 144 supersedes FAS 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of . FAS 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30 (APB 30), Reporting Results of Operations - Reporting the Effects of Disposal of a Segment of a Business . FAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale. FAS 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, FAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. The adoption of FAS 144 did not have a material impact on the Company s financial position or results of operations.

Note 3 Issuance of Preferred Stock and Restructuring of Debt:

In January 2002, the Company designated and authorized 4,000 shares of Series B Preferred Stock (the Series B Preferred), and issued 2,800 shares of Series B Preferred to Redwood West Coast, LLC (Redwood) in exchange for $2,800,000 cash, less

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Item 1. Financial Statements (continued)

SYNBIOTICS CORPORATION
Notes to Condensed Consolidated Financial Statements (unaudited)

$196,000 of issuance costs. Each Series B Preferred share is entitled to cumulative dividends, payable in cash quarterly, in an annual amount of $75 per share. The Series B Preferred is entitled to a liquidation preference of $1,000 per share, plus accumulated and unpaid dividends. Each share of Series B Preferred has voting power equivalent to 7,785 shares of common stock. Each share of Series B Preferred is convertible into 7,785 shares of common stock (subject to anti-dilution adjustments). Redwood representatives now constitute 100% of the Company s Board of Directors, and Redwood also controls approximately 54% of the Company s voting stock on a fully diluted basis. The Company agreed to pay an affiliate of Redwood a consulting fee of $15,000 per month beginning in February 2002. In October 2002, the Company entered into a Stock Swap Agreement with Redwood (Note 11) whereby the Company issued 2,800 shares of Series C Preferred to Redwood in exchange for Redwood s 2,800 shares of Series B Preferred.

In January 2002, in conjunction with the Redwood transaction, the Company amended cash retention bonus agreements with certain employees (the Converted Retention Bonuses) so that, instead of cash, the employees received, on May 15, 2002, an aggregate of 8,254,000 shares of the Company s common stock under the 1995 Stock Option/Stock Issuance Plan. The Company also agreed to pay the employees income tax withholding obligation related to the Converted Retention Bonuses in exchange for the cancellation of options outstanding for an aggregate of 880,000 shares of the Company s common stock. In January 2002, the Company recorded compensation expense, including the employees income tax withholding obligation, related to the Converted Retention Bonuses totalling $3,029,000. In addition, the Company also amended its remaining employee cash retention bonus agreements (the Cash Retention Bonuses) so that the amounts that would have become payable upon the consummation of the Redwood transaction will instead be payable in January 2003. The Company recorded compensation expense totalling $653,000 in January 2002 related to the Cash Retention Bonuses. The Cash Retention Bonuses also modified options to purchase an aggregate of 72,000 shares of the Company s common stock to provide for immediate vesting, upon consummation of the Redwood transaction, and to extend the expiration date to January 25, 2004. No compensation expense was recorded related to these modifications as the exercise prices of all of the options involved was greater than the fair market value of the shares on the modification date.

The Company amended its credit agreement with Comerica Bank California (Comerica) in conjunction with the Redwood transaction. The $7,132,000 principal amount outstanding under the Company s revolving line of credit and term note, each due in March 2002, was converted into a new $7,132,000 term note. The new note bears interest at the rate of prime plus 2%, and is payable in monthly installments of $100,000 plus accrued interest through January 2003 and monthly installments of $125,000 plus accrued interest thereafter, with all remaining principal due January 25, 2004. In addition, the Company must make a partial prepayment if its EBITDA (earnings before interest, taxes, depreciation and amortization) in 2002 exceeds $4,000,000. As of December 31, 2001, the Company was not in compliance with certain of the original Comerica financial covenants. The amended credit agreement waives all prior instances of non-compliance with financial covenants, and now includes only a minimal financial covenant related to capital expenditures.

Note 4 Discontinued Operations:

In August 2002, the Company sold its instrument manufacturing operations, located in Rome, New York, to Danam Acquisition Corp., located in Dallas, Texas, in exchange for a $500,000 note receivable. The note is payable, beginning in September 2002, in 60 monthly principal payments of $8,000 plus interest at 5%, is secured by the assets of the disposed operations (all of which had been previously written off by the Company), and is guaranteed by Drew Scientific Group PLC (the parent of Danam Acquisition Corp.)

The Company has recorded the $500,000 gain in discontinued operations. The Company has restated prior amounts related to the disposed operations. Revenue related to the discontinued operations for the three and nine months ended September 30, 2002 was $82,000 and $397,000, respectively, and pre-tax loss related to the discontinued operations for the three and nine months ended September 30, 2002 was $121,000 and $212,000, respectively. A reconciliation of the restated amounts for the three and nine months ended September 30, 2001 is as follows:

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Item 1. Financial Statements (continued)

SYNBIOTICS CORPORATION
Notes to Condensed Consolidated Financial Statements (unaudited)

	Three Months Ended September 30, 2001	Nine Months Ended September 30, 2001
	(unaudited)	(unaudited)
Amounts previously reported in:		
Net sales	$ 168,000	$ 614,000
Cost of sales	(93,000)	(445,000)
Research and development	(50,000)	(167,000)
Sales and marketing	(15,000)	(47,000)
General and administrative	(21,000)	(67,000)
Benefit from income taxes	1,000	15,000
Discontinued operations, net of tax	$ (10,000)	$ (97,000)

Note 5 - Inventories:

Inventories consist of the following:

	September 30, 2002	December 31, 2001
	(unaudited)	(audited)
Inventories:		
Raw materials	$ 2,741,000	$ 2,317,000
Work in process	515,000	318,000
Finished goods	2,725,000	2,424,000
	$ 5,981,000	$ 5,059,000

Note 6 Goodwill and Other Intangible Assets:

On January 1, 2002, the Company adopted FAS 142 (Note 2). As a result, the Company recorded an impairment loss and ceased to amortize goodwill. The Company has allocated all of its goodwill to its only reporting unit, which is also its only reportable segment (Note 9). Changes in the carrying amount of goodwill were as follows:

Balance at December 31, 2000	$ 13,161,000
Additional purchase price for prior acquisitions	277,000
Amortization	(1,445,000)
Effect of currency exchange rates	81,000
Balance at December 31, 2001	12,074,000
Impairment loss	(7,755,000)
Effect of currency exchange rates	(44,000)
Balance at September 30, 2002	$ 4,275,000

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Item 1. Financial Statements (continued)

SYNBIOTICS CORPORATION
Notes to Condensed Consolidated Financial Statements (unaudited)

The reconciliation of reported net (loss) income and net (loss) income per share for the three and nine months ended September 30, 2002 and 2001 was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Reported net (loss) income	$ (293,000)	$ (216,000)	$ (10,766,000)	$ 1,724,000
Add: Goodwill amortization		351,000		1,044,000
Adjusted net (loss) income	$ (293,000)	$ 135,000	$ (10,766,000)	$ 2,768,000
Basic and diluted net (loss) income per share:				
Reported net (loss) income	$ (0.02)	$ (0.02)	$ (0.80)	$ 0.17
Add: Goodwill amortization		0.04		0.11
Adjusted basic and diluted net (loss) income	$ (0.02)	$ 0.02	$ (0.80)	$ 0.28

Other intangible assets were as follows:

	September 30, 2002		December 31, 2001	
	Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization
Patents	$ 4,203,000	$ 1,729,000	$ 3,863,000	$ 1,313,000
Licenses	599,000	361,000	512,000	318,000
	$ 4,802,000	$ 2,090,000	$ 4,375,000	$ 1,631,000

The weighted-average amortization periods for patents and licenses are 9 years and 10 years, respectively, and the weighted-average amortization period for total intangible assets is 9 years. Annual pretax amortization for other intangibles over the next five years is estimated to be as follows:

2003	$ 475,000
2004	471,000
2005	438,000
2006	428,000
2007	321,000
	$ 2,133,000

Note 7 Mandatorily Redeemable Stock:

The Series B Preferred (Note 3) defines a merger and/or acquisition as a liquidating event; and as a result, the Series B Preferred is considered to be mandatorily redeemable and is classified outside of permanent shareholders equity on the balance sheet. The Series C Preferred (Note 11) does not define a merger and/or acquisition as a liquidating event; and as a result, the carrying amount of the Series C Preferred will be classified as a part of permanent shareholders equity on the balance sheet.

The 621,000 shares of the Company s common stock which were issued to Merial SAS (Merial) in conjunction with the 1997 acquisition of SBIO-E were subject to a put provision which gave Merial the right, beginning on July 9, 2001, to sell all or any

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Item 1. Financial Statements (continued)

SYNBIOTICS CORPORATION
Notes to Condensed Consolidated Financial Statements (unaudited)

portion of its shares to the Company at a price of $5 per share, for a total of $3,107,000. In June 2001, in conjunction with the assignment to Merial of the Company s feline leukemia virus (FeLV) vaccine distribution rights, Merial waived its rights under the put provision. However, if the Company failed to make certain royalty payments to Merial through April 2002, the rights under the put provision would have reverted to Merial. The Company made the final scheduled payment in April 2002, and reclassified the carrying amount of the common stock from mandatorily redeemable stock to permanent shareholders equity as of March 31, 2002.

Note 8 (Loss) Income per Share:

The following is a reconciliation of net (loss) income and share amounts used in the computations of (loss) income per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Basic and diluted net (loss) income used:				
(Loss) income from continuing operations	$ (633,000)	$ (206,000)	$ (3,378,000)	$ 1,821,000
Less cumulative preferred stock dividends	(53,000)		(143,000)	
Less accretion of mandatorily redeemable common stock				(79,000)
(Loss) income from continuing operations used in computing basic (loss) income from continuing operations per share	(686,000)	(206,000)	(3,521,000)	1,742,000
Discontinued operations, net of tax	340,000	(10,000)	261,000	(97,000)
Cumulative effect of a change in accounting principle, net of tax			(7,649,000)	
Net (loss) income used in computing basic and diluted net (loss) income per share	$ (346,000)	$ (216,000)	$ (10,909,000)	$ 1,645,000
Shares used:				
Weighted average common shares outstanding used in computing bas				