SYNERGETICS USA INC
Form 10-Q
December 14, 2010

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended October 31, 2010

o **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 001-10382

SYNERGETICS USA, INC.

(Exact name of registrant as specified in its charter)

Delaware	20-5715943
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3845 Corporate Centre Drive O Fallon, Missouri	63368
(Address of principal executive offices)	(Zip Code)

(636) 939-5100

(Registrant s Telephone Number, Including Area Code)

Indicate by check mark whether 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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer o	Accelerated Filer o	Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The number of shares outstanding of the issuer s common stock, $0.001 value per share, as of December 3, 2010 was 24,842,441 shares.

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Certification of Chief Executive Officer Pursuant to Section 302 of Sarbanes-Oxley Act of 2002
Certification of Chief Financial Officer Pursuant to Section 302 of Sarbanes-Oxley Act of 2002
Certification of Chief Executive Officer Pursuant to Section 906 of Sarbanes-Oxley Act of 2002
Certification of Chief Financial Officer Pursuant to Section 906 of Sarbanes-Oxley Act of 2002
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Part I Financial Information
Item 1 Unaudited Condensed Consolidated Financial Statements
Synergetics USA, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
As of October 31, 2010 (Unaudited) and July 31, 2010
(Dollars in thousands, except share data)

	October 31, 2010	July 31, 2010
Assets		
Current Assets		
Cash and cash equivalents	$ 18,519	$ 18,669
Accounts receivable, net of allowance for doubtful accounts of $293 and $282, respectively	9,132	9,056
Inventories	13,421	11,891
Prepaid expenses	530	792
Deferred income taxes	658	658
Total current assets	42,260	41,066
Property and equipment, net	8,044	8,044
Intangible and other assets		
Goodwill	10,690	10,690
Other intangible assets, net	12,180	12,353
Patents, net	897	870
Cash value of life insurance	72	72
Total assets	$ 74,143	$ 73,095
Liabilities and stockholders equity		
Current Liabilities		
Current maturities of long-term debt	$ 1,407	$ 1,398
Current maturities of revenue bonds payable	116	116
Accounts payable	1,844	1,800
Accrued expenses	2,694	2,624
Income taxes payable	254	11
Deferred revenue	400	400
Total current liabilities	6,715	6,349
Long-Term Liabilities		
Long-term debt, less current maturities	784	939
Revenue bonds payable, less current maturities	1,583	1,612
Deferred revenue	18,630	18,630
Deferred income taxes	1,264	1,339
Total long-term liabilities	22,261	22,520
Total liabilities	28,976	28,869

Commitments and contingencies (Note 8)				
Stockholders Equity				
Common stock at October 31, 2010 and July 31, 2010, $0.001 par value, 50,000,000 shares authorized; 24,842,441 and 24,772,155 shares issued and outstanding, respectively		**25**		25
Additional paid-in capital		**25,087**		24,905
Retained earnings		**19,952**		19,319
Accumulated other comprehensive income (loss):				
Foreign currency translation adjustment		**103**		(23)
Total stockholders equity	**$**	**45,167**	$	44,226
Total liabilities and stockholders equity	**$**	**74,143**	$	73,095

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Synergetics USA, Inc. and Subsidiaries
Consolidated Statements of Income
Three Months Ended October 31, 2010, and 2009
(Dollars in thousands, except share and per share data)

	Three Months Ended October 31, 2010	Three Months Ended October 31, 2009
Net sales	$ 12,076	$ 12,146
Cost of sales	5,053	5,219
Gross profit	7,023	6,927
Operating expenses		
Research and development	719	659
Sales and marketing	3,023	3,259
General and administrative	2,252	2,030
	5,994	5,948
Operating income	1,029	979
Other income (expenses)		
Investment income	32	
Interest expense	(80)	(168)
Miscellaneous	(7)	(10)
	(55)	(178)
Income before provision for income taxes	974	801
Provision for income taxes	341	259
Net income	$ 633	$ 542
Earnings per share:		
Basic	$ 0.03	$ 0.02
Diluted	$ 0.03	$ 0.02
Basic weighted average common shares outstanding	24,782,913	24,458,089
Diluted weighted average common shares outstanding	24,862,420	24,496,554

See Notes to Unaudited Condensed Consolidated Financial Statements.

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Synergetics USA Inc. and Subsidiaries
Consolidated Statements of Cash Flows
Three Months Ended October 31, 2010 and 2009
(Dollars in thousands, except share data)

	Three Months Ended October 31, 2010	Three Months Ended October 31, 2009
Cash Flows from Operating Activities		
Net income	**$ 633**	$ 542
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	**285**	257
Amortization	**196**	223
Provision for doubtful accounts receivable	**4**	(4)
Stock-based compensation	**70**	74
Deferred income taxes	**(75)**	(86)
(Gain) loss on sale of equipment		(15)
Changes in assets and liabilities		
(Increase) decrease in:		
Accounts receivable	**(13)**	1,086
Inventories	**(1,490)**	179
Prepaid expenses	**265**	9
(Decrease) increase in:		
Accounts payable	**37**	(652)
Accrued expenses	**65**	(34)
Income taxes payable	**243**	16
Net cash provided by operating activities	**220**	1,595
Cash Flows from Investing Activities		
Proceeds on the sale of equipment		15
Purchase of property and equipment	**(285)**	(198)
Acquisition of patents and other intangibles	**(50)**	(40)
Net cash used in investing activities	**(335)**	(223)
Cash Flows from Financing Activities		
Excess of outstanding checks over bank balance		354
Net borrowings (repayments) on lines-of-credit		(1,211)
Principal payments on revenue bonds payable	**(29)**	(51)
Principal payments on long-term debt		(123)
Payment on debt incurred for acquisition of trademark	**(146)**	(138)
Tax benefit associated with the exercise of non-qualified stock options	**43**	
Proceeds from the issuance of common stock	**69**	
Net cash used in financing activities	**(63)**	(1,169)

Foreign exchange rate effect on cash and cash equivalents		**28**		
Net (decrease) increase in cash and cash equivalents		**(150)**		203
Cash and cash equivalents				
Beginning		**18,669**		160
Ending	**$**	**18,519**	$	363

See Notes to Unaudited Condensed Consolidated Financial Statements.

Synergetics USA, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements
(Tabular information reflects dollars in thousands, except share and per share information)

Note 1. General

Nature of business: Synergetics USA, Inc. (Synergetics USA or the Company) is a Delaware corporation incorporated on June 2, 2005, in connection with the reverse merger of Synergetics, Inc. (Synergetics) and Valley Forge Scientific Corp. (Valley Forge) and the subsequent reincorporation of Valley Forge (the predecessor to Synergetics USA) in Delaware. Synergetics USA is a medical device company. Through continuous improvement and development of our people, our **mission** is to design, manufacture and market innovative microsurgical devices, capital equipment, accessories and disposables of the highest quality in order to assist and enable surgeons who perform microsurgery around the world to provide a better quality of life for their patients. The Company s primary focus is on the microsurgical disciplines of ophthalmology and neurosurgery. Our distribution channels include a combination of direct and independent sales organizations and important strategic alliances with market leaders. The Company is located in O Fallon, Missouri and King of Prussia, Pennsylvania. During the ordinary course of its business, the Company grants unsecured credit to its domestic and international customers.

Basis of presentation: The unaudited condensed consolidated financial statements include the accounts of Synergetics USA, Inc., and its wholly owned subsidiaries: Synergetics, Synergetics Development Company, LLC, Synergetics Delaware, Inc. and Synergetics IP, Inc. All significant intercompany accounts and transactions have been eliminated. The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring items) considered necessary for a fair presentation have been included. Operating results for the three months ended October 31, 2010, are not necessarily indicative of the results that may be expected for the fiscal year ending July 31, 2011. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements of the Company for the year ended July 31, 2010, and notes thereto filed with the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on October 12, 2010 (the Annual Report).

Note 2. Comprehensive Income

Comprehensive income was $126,000 for the three months ended October 31, 2010. The Company s only component of other comprehensive income is the foreign currency translation adjustment.

Note 3. Summary of Significant Accounting Policies

Reclassifications: Certain reclassifications have been made to the prior quarter s quarterly financial statements to conform to the current quarter s presentation which increased gross profit margin by $109,000, increased operating income by $39,000 and increased the miscellaneous expense by $39,000. However, net income was not affected.

The Company s significant accounting policies are disclosed in the Annual Report. In the first three months of fiscal 2011, no significant accounting policies were changed.

Note 4. Marketing Partner Agreements

The Company sells most of its electrosurgery generators and a portion of its neurosurgery instruments and accessories to two U.S. based national and international marketing partners as described below:

Codman & Shurtleff, Inc. (Codman)

In the neurosurgical market, the bipolar electrosurgical system manufactured by Valley Forge prior to the merger has been sold for over 25 years through a series of distribution agreements with Codman, an affiliate of Johnson & Johnson. On April 2, 2009, the Company executed a new, three-year distribution agreement with Codman for the continued distribution by Codman of certain bipolar generators and related disposables and accessories effective January 1, 2009. In addition, the Company entered into a new, three-year license agreement, which provides for the continued licensing of the Company s Malis® trademark to Codman for use with certain Codman products, including those covered by the distribution agreement. Both agreements expire on December 31, 2011.

On November 16, 2009, the Company announced the signing of an addendum to its three-year agreement with Codman. Under the terms of the revised agreement, Codman has the exclusive right to market and distribute the Company s Malis® branded disposable forceps produced by Synergetics. Codman began distribution of the disposable bipolar forceps on December 1, 2009, domestically and February 1, 2010, internationally.

Total sales to Codman and its respective percent of the Company s net sales in the three months ended October 31, 2010 and October 31, 2009, including the historical sales of generators, accessories and disposable cord tubing that the Company has supplied in the past, as well as the disposable bipolar forceps sales resulting from the addendum to the existing distribution agreement, were as follows (dollars in thousands):

	Three Months Ended October 31, 2010	Three Months Ended October 31, 2009
Net Sales	**$ 2,107**	$ 885
Percent of net sales	**17.4%**	7.3%

Stryker Corporation (Stryker)

The Company supplies a lesion generator used for minimally invasive pain treatment to Stryker pursuant to a supply and distribution agreement dated as of October 25, 2004. The original term of the agreement was for slightly over five years, commencing on November 11, 2004 and ending on December 31, 2009. On August 1, 2007, the Company negotiated a one-year extension to the agreement through December 31, 2010 and increased the minimum purchase obligation to 300 units per year for the remaining contract period. The Company is in the process of extending this agreement with Stryker.

On March 31, 2010, the Company entered into an additional strategic agreement with Stryker including the sale of accounts receivable, open sales orders, inventory and certain intellectual property related to the Omni® ultrasonic aspirator product line. The gain from the sale of the Omni® product line to Stryker was $817,000 in the third quarter of fiscal 2010. In addition, the agreement provides for the Company to supply disposable ultrasonic instrument tips and certain other consumable products used in conjunction with the ultrasonic aspirator console and handpieces and to pursue certain development projects for new products associated with Stryker s ultrasonic aspirator products.

Total sales to Stryker and its respective percent of the Company s net sales in the three months ended October 31, 2010, and October 31, 2009, including the historical sales of pain control generators, and accessories that the Company has supplied in the past, as well as the disposable ultrasonic instrument tips sales and certain other consumable products resulting from the new agreements, were as follows (dollars in thousands):

	Three Months Ended October 31, 2010	Three Months Ended October 31, 2009
Net Sales	**$ 1,360**	$ 589
Percent of net sales	**11.3%**	4.8%

No other customer comprises more than 10 percent of sales in any given quarter.

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Note 5. Stock-Based Compensation

Stock Option Plans

The following table provides information about stock-based awards outstanding at October 31, 2010:

	Shares	Weighted Average Exercise Price	Weighted Average Fair Value
Options outstanding beginning of period	**576,695**	**$ 1.71**	**$ 2.08**
For the period August 1, 2010 through October 31, 2010			
Granted			
Forfeited			
Exercised	**62,000**	**$ 0.99**	**$ 1.13**
Options outstanding, end of period	**514,695**	**$ 1.80**	**$ 2.20**
Options exercisable, end of period	**419,112**	**$ 1.97**	**$ 2.40**

There were no options granted in the first quarter of fiscal 2011. Each independent director receives an option to purchase 10,000 shares of the Company s Common Stock each year in which he or she is elected, appointed, or re-elected to serve as a director pursuant to the Amended and Restated 2005 Non-Employee Directors Stock Option Plan. These options vest pro-ratably on a quarterly basis over the next year of service on the Board. During the second quarter of fiscal 2010, there were options to purchase 40,000 shares of the Company s Common Stock granted to the Company s independent directors, which vest pro-ratably on a quarterly basis over the next year of service. The Company recorded $11,000 of compensation expense for the three months ended October 31, 2010 with respect to these options.

During the second quarter of fiscal 2010, there were options to purchase 35,000 shares of Common Stock granted to the Chief Executive Officer (CEO), and options to purchase 17,500 shares of Common Stock granted to each of the Chief Operations Officer (COO), the Chief Scientific Officer (CSO) and the Chief Financial Officer (CFO). The options granted to the officers of the Company were granted in conjunction with the Company s annual review of compensation as of August 1, 2009 and vest pro-ratably on a quarterly basis over the next five years of service. The Company recorded $8,000 of compensation expense for the three months ended October 31, 2010 with respect to these options.

The Company expects to issue new shares as options are exercised. As of October 31, 2010, the future compensation cost expected to be recognized for currently outstanding stock options is approximately $31,000 for the remainder of fiscal 2011, $22,000 in fiscal 2012, $19,000 in fiscal 2013, $19,000 in fiscal 2014 and $8,000 in fiscal 2015.

Restricted Stock Plans

Under our Amended and Restated Synergetics USA, Inc. 2001 Stock Plan (2001 Plan), our Common Stock may be granted at no cost to certain employees and consultants of the Company. Certain plan participants are entitled to cash dividends and voting rights for their respective shares. Restrictions limit the sale or transfer of these shares during a vesting period whereby the restrictions lapse either pro-ratably over a five-year vesting period or at the end of the fifth year. These shares also vest upon a change of control event. Upon issuance of stock under the 2001 Plan, unearned compensation equivalent to the market value at the date of the grant is charged to stockholders equity and subsequently amortized to expense over the applicable restriction period. As of October 31, 2010, there was approximately $338,000 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the 2001 Plan. The cost is expected to be recognized over a weighted-average period of five years. The following table provides information about restricted stock grants during the three month period ended October 31, 2010:

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	Number of Shares	Weighted Average Grant Date Fair Value
Balance as of July 31, 2010	**286,961**	**$ 2.04**
Granted		
Forfeited		
Balance as of October 31, 2010	**286,961**	**$ 2.04**

Note 6. Fair Value Information

Fair value is an exit price that represents the amount that would be received upon sale of an asset or paid to transfer a liability in an orderly transaction between market participants.

The Company does not have any financial assets which are required to be measured at fair value on a recurring basis. Non-financial assets such as goodwill, intangible assets and property, plant and equipment are measured at fair value when there is an indicator of impairment and recorded at fair value only when impairment is recognized. No impairment indicators existed as of October 31, 2010.

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses approximate fair value because of the short maturity of these items. The carrying amount of the Company s notes and revenue bonds payable and long-term debt is estimated to approximate fair value because the variable interest rates or the fixed interest rates are based on estimated current rates offered to the Company for debt with similar terms and maturities.

Note 7. Supplemental Balance Sheet Information

Inventories: Inventories as of October 31, 2010 and July 31, 2010 were as follows (dollars in thousands):

	October 31, 2010	July 31, 2010
Raw material and component parts	**$ 5,614**	$ 5,225
Work in progress	**2,807**	2,050
Finished goods	**5,000**	4,616
	$ 13,421	$ 11,891

Property and Equipment: Property and equipment as of October 31, 2010 and July 31, 2010 were as follows (dollars in thousands):

	October 31, 2010	July 31, 2010
Land	**$ 730**	$ 730
Building and improvements	**5,930**	5,929
Machinery and equipment	**6,554**	6,136
Furniture and fixtures	**720**	736
Software	**363**	363
Construction in progress	**97**	232
	14,394	14,126

Less accumulated depreciation		**6,350**		6,082
	$	**8,044**	$	8,044

Other Intangible Assets: Information regarding the Company s other intangible assets as of October 31, 2010 are as follows (dollars in thousands):

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	Gross Carrying Value	Accumulated Amortization	Net
		October 31, 2010	
Proprietary know-how	**$ 4,057**	**$ 1,606**	**$ 2,451**
Trademark	**5,923**		**5,923**
Licensing agreement	**5,834**	**2,028**	**3,806**
Patents	**1,437**	**540**	**897**
	$ 17,251	**$ 4,174**	**$ 13,077**
		July 31, 2010	
Proprietary know-how	$ 4,057	$ 1,544	$ 2,513
Trademark	5,923		5,923
Licensing agreement	5,834	1,917	3,917
Patents	1,387	517	870
	$ 17,201	$ 3,978	$ 13,223

Goodwill of $10,660,000 and proprietary know-how of $4,057,000 are a result of the reverse merger transaction completed on September 21, 2005.

The Company did not incur costs to renew or extend the term of acquired intangible assets during the period ended October 31, 2010. Estimated amortization expense on other intangibles for the remaining nine months of the fiscal year ending July 31, 2011, and the next four years thereafter is as follows:

	Amount
Fiscal Year 2011 (remaining 9 months)	$ 440
Fiscal Year 2012	587
Fiscal Year 2013	587
Fiscal Year 2014	587
Fiscal Year 2015	587

Amortization expense for the three months ended October 31, 2010 was $196,000.

Pledged assets; short and long-term debt (excluding revenue bonds payable): Short-term debt as of October 31, 2010 and July 31, 2010, consisted of the following:

Revolving Credit Facility: The Company has a credit facility with a bank which allows for borrowings of up to $9.5 million (collateral available on October 31, 2010 permits borrowings up to $8.2 million) with an interest rate based on either the one-, two- or three-month LIBOR plus 2.0 percent and adjusting each quarter based upon our leverage ratio. As of October 31, 2010, interest under the facility is charged at 2.26 percent. The unused portion of the facility is charged at a rate of 0.20 percent. There were no borrowings under this facility at October 31, 2010. Outstanding amounts are collateralized by the Company s domestic receivables and inventory. This credit facility was amended on November 30, 2010, to extend the termination date through November 30, 2011.

The facility has two financial covenants: a maximum leverage ratio of 3.75 times and a minimum fixed charge coverage ratio of 1.1 times. As of October 31, 2010, the leverage ratio was 1.36 times and the minimum fixed charge coverage ratio was 1.88 times. Collateral availability under the line as of October 31, 2010, was approximately

$8.2 million. The facility restricts the payment of dividends if, following the distribution, the fixed charge coverage ratio would fall below the required minimum.

Non-U.S. Receivables Revolving Credit Facility: The Company had a non-U.S. receivables credit facility with a bank which allowed for borrowings of up to $1.75 million with an interest rate based on LIBOR plus 3.0%. Pursuant to the terms of this facility, under no circumstances shall the rate be less than

3.5 percent per annum. The facility charged an administrative fee of 1.0 percent. There were no borrowings under this facility at October 31, 2010. Outstanding amounts were collateralized by the Company s non-U.S. receivables. This credit facility had no financial covenants and was terminated on November 30, 2010.

Equipment Line of Credit: Under this credit facility, the Company may borrow up to $1.0 million, with interest at one-month LIBOR plus 3.0 percent. Pursuant to the terms of the equipment line of credit, under no circumstances shall the rate be less than 3.5 percent per annum. The unused portion of the facility is not charged a fee. There were no borrowings under this facility at October 31, 2010. The equipment line of credit was amended on November 30, 2010, to extend the maturity date to November 30, 2011.

Long-term debt as of October 31, 2010 and July 31, 2010 consisted of the following (dollars in thousands):

	October 31, 2010	July 31, 2010
Note payable to the estate of the late Dr. Leonard I. Malis, due in quarterly installments of $159,904 which includes interest at an imputed rate of 6.0 percent; remaining balance of $799,520 including the effects of imputing interest, due December 2011, collateralized by the Malis® trademark	**$ 765**	$ 911
Settlement obligation to Iridex Corporation (Iridex), due in annual installments of $800,000 which includes interest at an imputed rate of 8.0 percent; remaining balance of $1,600,000 including the effects of imputing interest, due April 15, 2012	**1,426**	1,426
Total	**$ 2,191**	$ 2,337
Less current maturities	**1,407**	1,398
Long-term portion	**$ 784**	$ 939

Note 8. Commitments and Contingencies

Effective January 29, 2009, the Company s Board of Directors appointed David M. Hable to serve as President and CEO. Also on that date, the Company entered into a change in control agreement with Mr. Hable. On December 9, 2009, the Company entered into a change in control agreement with each of its COO and CSO, which agreements were contemplated in conjunction with the Company s annual review of compensation and therefore, the agreements were made effective with other compensation changes as of August 1, 2009. On October 12, 2010, the Company entered into a change of control agreement with its CFO, which agreement was contemplated in conjunction with the Company s annual review of compensation; therefore, the agreement was made effective with other compensation changes as of August 1, 2010. The change in control agreements with the CEO, COO, CFO and CSO each provide that if employment is terminated within one year following a change in control for cause or disability (as each term is defined in the change in control agreement), as a result of the officers death, or by the officer other than as an involuntary termination (as defined in the change in control agreement), the Company shall pay the officer all compensation earned or accrued through his or her employment termination date, including (i) base salary; (ii) reimbursement for reasonable and necessary expenses; (iii) vacation pay; (iv) bonuses and incentive compensation; and (v) all other amounts to which they are entitled under any compensation or benefit plan of the Company (Standard Compensation Due).

If the officer s employment is terminated within one year following a change in control without cause and for any reason other than death or disability, including an involuntary termination, and provided the officer enters into a separation agreement within 30 days of his or her employment termination, he or she shall receive the following: (i) all Standard Compensation Due and any amount payable as of the termination date under the Company s objectives-based incentive plan, the sum of which shall be paid in a lump sum immediately upon such termination; and (ii) an amount equal to one times his or her annual base salary at the rate in effect immediately prior to the change in control, to be paid in 12 equal monthly installments beginning in the month following his or her employment

termina