

DERMA SCIENCES, INC.
Form 10-Q
May 15, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

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 1-31070

Derma Sciences, Inc.

(Exact name of registrant as specified in its charter)

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Delaware 23-2328753
(State or other jurisdiction of Incorporation) (IRS employer identification number)

214 Carnegie Center, Suite 300

Princeton, NJ 08540

(Address of principal executive offices)

(609) 514-4744

(Issuer's telephone number)

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 No

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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.

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Date: May 14, 2013 Class: Common Stock, par value \$.01 per share
Shares Outstanding: 16,976,659

PART I – FINANCIAL INFORMATION

DERMA SCIENCES, INC.

FORM 10-Q

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Part I – Financial Information**Item 1. Financial Statements.**

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets (Unaudited)

ASSETS	March 31, 2013	December 31, 2012
<u>Current Assets</u>		
Cash and cash equivalents	\$38,453,049	\$41,616,657
Short-term investments	3,720,000	3,730,000
Accounts receivable, net	6,933,383	7,085,713
Inventories	13,252,222	13,670,588
Prepaid expenses and other current assets	3,118,539	3,209,031
Total current assets	65,477,193	69,311,989
Long-term investments	1,494,000	498,000
Equipment and improvements, net	3,147,091	3,304,852
Identifiable intangible assets, net	16,486,847	17,128,883
Goodwill	13,457,693	13,457,693
Other assets	140,154	141,213
Total Assets	\$100,202,978	\$103,842,630
 LIABILITIES AND STOCKHOLDERS' EQUITY		
<u>Current Liabilities</u>		
Accounts payable	\$4,596,319	\$3,993,687
Accrued expenses and other current liabilities	3,196,972	4,132,934
Total current liabilities	7,793,291	8,126,621
Long-term liabilities	293,113	268,517
Deferred tax liability	1,678,093	1,736,299
Total Liabilities	9,764,497	10,131,437
Stockholders' Equity		
Convertible preferred stock, \$.01 par value; 1,468,750 shares authorized; issued and outstanding 73,332 at March 31, 2013 and December 31, 2012 (liquidation preference of \$3,222,368 at March 31, 2013)	733	733
Common stock, \$.01 par value; shares authorized 25,000,000; issued and outstanding 16,765,347 at March 31, 2013 and 16,524,723 at December 31, 2012	167,653	165,247
Additional paid-in capital	135,182,428	132,163,083

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Accumulated other comprehensive income – cumulative translation adjustments	1,539,203	1,588,888
Accumulated deficit	(46,451,536)	(40,206,758)
Total Stockholders' Equity	90,438,481	93,711,193
Total Liabilities and Stockholders' Equity	\$100,202,978	\$103,842,630

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES**Consolidated Statements of Comprehensive Loss (Unaudited)**

	Three Months Ended	
	March 31,	
	2013	2012
Net Sales	\$ 18,789,746	\$ 15,277,366
Cost of sales	12,085,281	10,401,206
Gross Profit	6,704,465	4,876,160
Operating Expenses		
Selling, general and administrative	9,853,085	6,359,090
Research and development	2,993,166	1,114,698
Total operating expenses	12,846,251	7,473,788
Operating loss	(6,141,786)	(2,597,628)
Other expense (income), net:		
Interest income	(6,023)	(5,079)
Other expense (income) net	94,827	(54,884)
Total other expense (income) , net	88,804	(59,963)
Loss before income taxes	(6,230,590)	(2,537,665)
Income tax expense	14,188	1,236
Net Loss	(6,244,778)	(2,538,901)
Other Comprehensive (Loss) Income		
Foreign currency translation adjustment	(49,685)	79,340
Comprehensive Loss	\$(6,294,463)	\$(2,459,561)
Net loss per common share – basic and diluted	\$(0.38)	\$(0.24)
Shares used in computing net loss per common share – basic and diluted	16,593,677	10,610,111

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

	Three Months Ended March 31,	
	2013	2012
Operating Activities		
Net loss	\$(6,244,778)	\$(2,538,901)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation of equipment and improvements	238,394	252,762
Amortization of intangible assets	742,037	227,078
Provision (recovery) for bad debts	7,000	(6,000)
Allowance for sales adjustments	(30,612)	(8,098)
Provision for inventory obsolescence	33,931	(6,182)
Deferred rent expense	28,757	(22,289)
Stock based compensation	1,490,091	494,918
Deferred income taxes	32,209	30,372
Changes in operating assets and liabilities:		
Accounts receivable	141,533	1,134,629
Inventories	308,122	(1,614,237)
Prepaid expenses and other current assets	109,441	(54,780)
Other assets	(6,072)	(14,683)
Accounts payable	614,551	(221,326)
Accrued expenses and other current liabilities	(1,073,097)	406,071
Net cash used in operating activities	(3,608,493)	(1,940,666)
Investing Activities		
Purchase of investments	(2,479,000)	(1,244,000)
Proceeds from sale of investments	1,493,000	1,742,000
Purchase of equipment and improvements	(133,733)	(175,098)
Net cash (used in) provided by investing activities	(1,119,733)	322,902
Financing Activities		
Proceeds from exercise of stock options and warrants, net of costs	1,608,106	275,938
Payment of withholding taxes related to employee stock compensation	(76,446)	(68,190)
Net cash provided by financing activities	1,531,660	207,748
Effect of exchange rate changes on cash and cash equivalents	32,958	(19,585)
Net decrease in cash and cash equivalents	(3,163,608)	(1,429,601)
Cash and cash equivalents		
Beginning of period	41,616,657	17,110,350
End of period	\$38,453,049	\$15,680,749
Supplemental disclosures of cash flow information:		
Liability accrued in connection with acquisition of an identifiable intangible asset and recognition of a refundable deposit	\$200,000	\$-

Cash paid during the year for:		
Interest	\$-	\$908

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiaries (the “Company”) is a medical technology company focused on three segments of the wound care marketplace: advanced wound care, traditional wound care and pharmaceutical wound care products. The Company has one drug candidate that initiated its Phase 3 study during the first quarter of 2013. The Company markets its products principally through direct sales representatives in the United States (“U.S.”), Canada and the United Kingdom (“U.K.”), and through independent distributors within other select international markets. The Company’s U.S. distribution facilities are located in St. Louis, Missouri and Houston, Texas. The Company utilizes third party distributors for distribution in Canada, Europe and the Far East. The Company also has manufacturing facilities in Toronto, Canada and Nantong, China.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. for interim financial information and with the instructions to Form 10-Q and Article 8 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2013, are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. Information included in the consolidated balance sheet as of December 31, 2012 has been derived from the consolidated financial statements and footnotes thereto for the year ended December 31, 2012, included in the Annual Report on Form 10-K previously filed with the Securities and Exchange Commission. For further information refer to the Annual Report on Form 10-K.

Principles of Consolidation – The consolidated financial statements include the accounts of Derma Sciences, Inc. and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates – The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Although these estimates are based on knowledge of current events and actions which may be undertaken in the future, actual results

may ultimately differ from these estimates. Estimates and assumptions are required in the determination of sales deductions for trade rebates, sales incentives, discounts and allowances. Significant estimates and assumptions are also required in determining the appropriateness of amortization periods for identifiable intangible assets, the potential impairment of goodwill and the valuation of inventory.

Revenue Recognition – Sales are recorded when product is shipped or title passes to customers and collectability is reasonably assured. Gross sales are adjusted for cash discounts, returns and allowances, trade rebates, distribution fees (in Canada) and other sales deductions in the same period that the related sales are recorded. Freight costs billed to and reimbursed by customers are recorded as a component of revenue. Freight costs to ship product to customers are recorded as a component of cost of sales.

Net Loss per Share – Net loss per common share – basic is computed by dividing net loss by the weighted average number of common shares outstanding for the period. Net loss per common share – diluted reflects the potential dilution of earnings by including the effects of the assumed exercise, conversion or issuance of potentially issuable shares of common stock (“potentially dilutive securities”), including those attributable to stock options, warrants, convertible preferred stock and restricted stock units in the weighted average number of common shares outstanding for a period, if dilutive. The effects of the assumed exercise of warrants and stock options are determined using the treasury stock method. Potentially dilutive securities have not been included in the computation of diluted loss per share for the three months ended March 31, 2013 and 2012 as the effect would be anti-dilutive.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

Potentially dilutive shares excluded as a result of the effects being anti-dilutive are as follows:

	Three Months Ended March 31,	
	2013	2012
Dilutive shares:		
Convertible preferred stock	73,332	73,332
Additional stock issuable related to conversion of preferred stock	189,205	-
Restricted share units	764,000	57,900
Warrants	2,743,050	3,035,036
Stock options	1,794,401	1,675,124
Total dilutive shares	5,563,988	4,841,392

2. Acquisition

On April 16, 2012, the Company acquired all of the outstanding stock of MedEfficiency, Inc. (“MedEfficiency”) pursuant to the terms of an Agreement and Plan of Merger. The purchase price was \$14,475,000 and was funded by the Company with cash on hand.

MedEfficiency develops, manufactures and markets medical devices for treating chronic wounds and lower extremity injuries, specializing in total contact casting (“TCC”) products. The TCC-EZ total contact cast system is MedEfficiency’s lead product, in addition to a line of traditional and specialized contact casts and related equipment. The Company has distributed MedEfficiency’s TCC products since 2008 under an exclusive distribution agreement.

The acquisition has been accounted for as a purchase. Accordingly, the results of operations of MedEfficiency have been included in the consolidated financial statements commencing April 17, 2012. The allocation of the purchase price to the estimated fair value of the assets acquired and the liabilities assumed is outlined below:

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Current assets	\$925,817
Equipment	29,579
Acquired intangible assets	10,700,000
Goodwill	6,337,967
 Total assets acquired	 17,993,363
 Current liabilities	 653,315
Deferred tax liability	2,982,470
 Total liabilities assumed	 3,635,785
Net assets acquired	\$14,357,578
 Purchase price	 \$14,475,000
Less cash acquired	117,422
Net cash paid	\$14,357,578

The allocation of the purchase price to the assets acquired and liabilities assumed was based on an independent valuation study to establish the fair value of the assets, liabilities and the identifiable intangible assets acquired. The identifiable intangible assets acquired consist of developed technology and patents, customer relationships, a supply agreement, trade names and trademarks and non-compete agreements. The Company recorded the excess of the purchase price over the fair values of the identifiable assets acquired and liabilities assumed as goodwill. While the acquired intangible assets are amortizable for financial reporting purposes, the acquired intangible assets and goodwill are not deductible for tax purposes. Deferred taxes have been recorded associated with the acquisition for the basis differences for financial reporting and income tax purposes for the acquired identifiable intangible assets at the effective tax rates for the period in which the deferred tax asset and liability are expected to reverse.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

The unaudited pro forma information below presents combined results of operations as if the acquisition had occurred at the beginning of the period presented instead of April 16, 2012. The pro forma information is based on historical results adjusted for the effect of purchase accounting and is not necessarily indicative of the results of operations of the combined entity had the acquisition occurred at the beginning of the periods presented, nor is it necessarily indicative of future results.

	Three Months Ended March 31, 2012
Net Sales	\$ 16,522,400
Net Loss	\$(730,007)
Net Loss per common share - basic and diluted	\$(0.07)
Weighted average number of shares - basic and diluted	10,610,111

The proforma results of operations reflect a deferred income tax benefit of \$1,962,972 associated with the acquisition for differences in financial and income tax reporting basis differences of the acquired identifiable intangible assets at the effective tax rates for the period in which the deferred tax assets and liabilities are expected to reverse.

3. Cash and Cash Equivalents and Investments

The Company considers cash and cash equivalents as amounts on hand, on deposit in financial institutions and highly liquid investments purchased with an original maturity of three months or less. The Company considers highly liquid investments purchased with an original maturity greater than three months as investments. Investments with maturities greater than one year from the balance sheet date are classified as a long-term asset.

Cash and cash equivalents and investments at March 31, 2013 and December 31, 2012 consisted of the following:

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	March 31, 2013	December 31, 2012
Cash	\$4,980,842	\$4,909,663
Money market mutual funds	33,472,207	36,706,994
Cash and cash equivalents	38,453,049	41,616,657
Investments	5,214,000	4,228,000
Total cash and cash equivalents and investments	\$43,667,049	