

DERMA SCIENCES, INC.
Form 10-Q
November 12, 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 September 30, 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)

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

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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

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

Date: November 11, 2013 Class: Common Stock, par value \$.01 per share
Shares Outstanding: 17,285,084

PART I – FINANCIAL INFORMATION

DERMA SCIENCES, INC.

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

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Balance Sheets (Unaudited)

	September 30, 2013	December 31, 2012
ASSETS		
Current Assets		
Cash and cash equivalents	\$5,393,788	\$41,616,657
Short-term investments	20,726,000	3,730,000
Accounts receivable, net	8,510,456	7,085,713
Inventories	15,087,585	13,670,588
Prepaid expenses and other current assets	3,342,859	3,209,031
Total current assets	53,060,688	69,311,989
Long-term investments	9,186,931	498,000
Equipment and improvements, net	3,033,174	3,304,852
Identifiable intangible assets, net	15,084,600	17,128,883
Goodwill	13,457,693	13,457,693
Other assets	140,303	141,213
Total Assets	\$93,963,389	\$103,842,630
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Accounts payable	\$5,338,091	\$3,993,687
Accrued expenses and other current liabilities	4,226,018	4,132,934
Total current liabilities	9,564,109	8,126,621
Long-term liabilities	262,584	268,517
Deferred tax liability	1,678,060	1,736,299
Total Liabilities	11,504,753	10,131,437
Commitments and contingencies (Note 10)		
Stockholders' Equity		
Convertible preferred stock, \$.01 par value; shares authorized 1,468,750; issued and outstanding 73,332 at September 30, 2013 and December 31, 2012 (liquidation preference of \$3,222,368 at September 30, 2013)	733	733
Common stock, \$.01 par value; shares authorized 35,000,000; issued and outstanding 17,268,486 at September 30, 2013 and 16,524,723 at December 31, 2012	172,685	165,247

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Additional paid-in capital	139,051,638	132,163,083
Accumulated other comprehensive income	1,978,560	1,588,888
Accumulated deficit	(58,744,980)	(40,206,758)
Total Stockholders' Equity	82,458,636	93,711,193
Total Liabilities and Stockholders' Equity	\$93,963,389	\$103,842,630

See accompanying consolidated notes.

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

	Three Months Ended September 30,	
	2013	2012
Net Sales	\$ 22,080,434	\$ 19,649,773
Cost of sales	14,046,660	12,741,599
Gross Profit	8,033,774	6,908,174
Operating Expenses		
Selling, general and administrative	10,743,489	8,058,441
Research and development	2,677,539	1,923,670
Total operating expenses	13,421,028	9,982,111
Operating loss	(5,387,254)	(3,073,937)
Other income, net:		
Interest income	(16,510)	(2,454)
Other income, net	(144,226)	(66,781)
Total other income, net	(160,736)	(69,235)
Loss before income taxes	(5,226,518)	(3,004,702)
Income tax (benefit) provision	(277,755)	50,304
Net Loss	(4,948,763)	(3,055,006)
Other Comprehensive Income		
Foreign currency translation adjustment	29,061	156,283
Unrealized gain on equity securities, net of taxes	579,711	-
Total other comprehensive income	608,772	156,283
Comprehensive Loss	\$ (4,339,991)	\$ (2,898,723)
Net loss per common share – basic and diluted	\$ (0.29)	\$ (0.24)
Shares used in computing net loss per common share – basic and diluted	17,262,688	12,875,476

See accompanying consolidated notes.

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

	Nine Months Ended September 30,	
	2013	2012
Net Sales	\$ 59,018,241	\$ 52,536,938
Cost of sales	37,605,841	34,554,029
Gross Profit	21,412,400	17,982,909
Operating Expenses		
Selling, general and administrative	31,419,944	23,646,715
Research and development	8,913,303	4,553,697
Total operating expenses	40,333,247	28,200,412
Operating loss	(18,920,847)	(10,217,503)
Other income, net:		
Interest income	(30,561)	(13,304)
Other income, net	(58,102)	(65,596)
Total other income, net	(88,663)	(78,900)
Loss before income taxes	(18,832,184)	(10,138,603)
Income tax benefit	(293,969)	(1,752,647)
Net Loss	(18,538,215)	(8,385,956)
Other Comprehensive Income (Loss)		
Foreign currency translation adjustment	(190,039)	149,113
Unrealized gain on equity securities, net of taxes	579,711	-
Total other comprehensive income	389,672	149,113
Comprehensive Loss	\$ (18,148,543)	\$ (8,236,843)
Net loss per common share – basic and diluted	\$ (1.09)	\$ (0.69)
Shares used in computing net loss per common share – basic and diluted	16,977,524	12,068,520

See accompanying consolidated notes.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Unaudited)

	Nine Months Ended September 30,	
	2013	2012
Operating Activities		
Net loss	\$ (18,538,215)	\$ (8,385,956)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation of equipment and improvements	689,948	771,402
Amortization of intangible assets	2,144,283	1,177,804
Provision for bad debts	21,000	8,080
Allowance for sales adjustments	18,122	35,610
Provision for inventory obsolescence	109,862	171,595
Loss on disposal of equipment	—	25,885
Deferred rent expense	1,019	740
Stock based compensation	4,161,221	1,670,288
Deferred income taxes	(234,934)	(1,799,970)
Changes in operating assets and liabilities:		
Accounts receivable	(1,458,367)	(103,287)
Inventories	(1,694,372)	(3,847,932)
Prepaid expenses and other current assets	(279,008)	289,395
Other assets	(26,094)	(3,735)
Accounts payable	1,368,750	367,390
Accrued expenses and other current liabilities	127,149	195,562
Net cash used in operating activities	(13,589,636)	(9,427,129)
Investing Activities		
Investment in acquired business, net of cash acquired	—	(14,357,578)
Purchase of investments	(33,723,000)	(4,976,000)
Proceeds from sale of investments	8,980,000	5,725,000
Purchase of equipment and improvements	(503,652)	(610,246)
Proceeds from sale of equipment	—	43,000
Purchase of identifiable intangible assets	(100,000)	(1,300,000)
Net cash used in investing activities	(25,346,652)	(15,475,824)
Financing Activities		
Proceeds from sale of common stock, net of costs	-	17,799,874
Proceeds from exercise of stock options and warrants, net of costs	2,811,218	963,759
Payment of withholding taxes related to employee stock compensation	(76,446)	(76,039)
Net cash provided by financing activities	2,734,772	18,687,594
Effect of exchange rate changes on cash and cash equivalents	(21,353)	243
Net decrease in cash and cash equivalents	(36,222,869)	(6,215,116)
Cash and cash equivalents		
Beginning of period	41,616,657	17,110,350

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End of period	\$ 5,393,788	\$ 10,895,234
Supplemental disclosures of cash flow information:		
Cash paid during the year for:		
Interest	\$ 719	\$ 1,724

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 nine months ended September 30, 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 and nine months ended September 30, 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 and Nine Months Ended September 30,	
	2013	2012
Dilutive shares:		
Convertible preferred stock	73,332	73,332
Additional stock issuable related to conversion of preferred stock	59,154	-
Restricted share units	802,800	52,900
Warrants	2,305,272	2,951,404
Stock options	1,832,581	1,704,110
Total dilutive shares	5,073,139	4,781,746

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:

Current assets	\$925,817
Equipment	29,579

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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 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 periods 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.

	Nine months ended, September 30, 2012 (Unaudited)
Net Sales	\$ 53,924,427
Net Loss	\$ (8,898,587)
Net Loss per common share: Basic and Diluted	\$ (0.74)
Weighted average number of shares: Basic and Diluted	12,068,520

The proforma results of operations for the nine months ended September 30, 2013 include a deferred income tax benefit of \$1,934,153 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**Cash and Cash Equivalents**

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 maintains cash with various domestic and foreign financial institutions within the ordinary course of business, which at times may exceed jurisdictional insurance limits. Money market mutual funds consist of funds deposited into mutual funds investing in U.S. government obligations that are fully secured by the U.S. government.

Investments

Investments in debt securities include certificates of deposit purchased with an original maturity greater than three months which are deposited in various U.S. financial institutions and are fully insured by the Federal Deposit Insurance Corporation. The Company intends to hold the certificate of deposits to maturity and accordingly these investments are carried at cost. Investment in equity securities include shares of Comvita Limited stock (see note 9) which are classified as an available for sale investment carried at fair value, and any unrealized gains and losses associated with the investment are included in accumulated other comprehensive income. Investment in debt securities with maturities greater than one year from the balance sheet date and the investment in shares of Comvita Limited stock are classified as a long-term asset.

