SYNERGETICS USA INC
Form 10-Q
March 15, 2006

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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 January 30, 2006

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 000-51602

SYNERGETICS USA, INC.

(Exact name of registrant as specified in its charter)

Delaware	23-2131580
(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer 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 March 10, 2006 was 24,082,735 shares.

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Part I Financial Information

Item 1 Unaudited Condensed Consolidated Financial Statements

Synergetics USA, Inc. and Subsidiaries
Unaudited Condensed Consolidated Balance Sheets
As of January 30, 2006 and July 31, 2005

	January 30, 2006	July 31, 2005
Assets		
Current Assets		
Cash and cash equivalents	**$ 549,584**	$ 1,816,823
Investment in trading securities	**40,333**	29,333
Accounts receivable, net of allowance for doubtful accounts of approximately $87,000 and $135,000, respectively	**5,791,116**	3,344,214
Notes receivable, officer-stockholder	**25,707**	
Inventories	**10,319,822**	7,188,636
Prepaid expenses	**423,074**	220,903
Deferred income taxes	**244,317**	157,000
Other	**301,204**	
Total current assets	**17,695,157**	12,756,909
Property and equipment, net	**8,044,494**	6,483,307
Goodwill	**10,788,565**	
Other intangible assets, net	**10,513,404**	846,008
Other assets, cash value of life insurance	**29,545**	29,545
Total assets	**$ 47,071,165**	$ 20,115,769
Liabilities and Stockholders Equity		
Current Liabilities		
Lines-of-credit	**$ 1,211,132**	$ 235,000
Current maturities of long-term debt	**953,087**	276,771
Current maturities of revenue bonds payable	**248,750**	248,750
Accounts payable	**2,067,953**	1,148,082
Accrued construction costs and expenses	**1,443,403**	1,748,686
Income taxes payable	**299,113**	311,684
Total current liabilities	**6,223,438**	3,968,973
Long-Term Liabilities		
Long-term debt, less current maturities	**3,702,328**	1,250,939
Revenue bonds payable, less current maturities	**4,264,167**	4,388,542
Deferred income taxes	**2,836,811**	343,000
Deferred compensation	**25,519**	25,519
Total long-term liabilities	**10,828,825**	6,008,000
Total liabilities	**17,052,263**	9,976,973

Stockholders Equity				
Common stock at January 30, 2006 and July 31, 2005, $.001 par value, 50,000,000 shares authorized and $0.01667 par value, 8,000,000 shares authorized, respectively; 24,015,238 and 3,542,111 shares issued, respectively; 23,913,863 and 3,456,773 shares outstanding, respectively		**24,016**		59,047
Additional paid-in capital		**23,249,025**		4,985,936
Retained earnings		**6,745,861**		5,401,816
		30,018,902		10,446,799
Less: Treasury stock				308,003
Total stockholders equity		**30,018,902**		10,138,796
Total liabilities and stockholders equity	**$**	**47,071,165**	$	20,115,769

See Notes to Unaudited Condensed, Consolidated Financial Statements.

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Synergetics USA, Inc. and Subsidiaries
Unaudited Condensed Consolidated Statements of Income
Three and Six Months Ended January 30, 2006 and January 31, 2005

	Three Months Ended January 30, 2006	Three Months Ended January 31, 2005	Six Months Ended January 30, 2006	Six Months Ended January 31, 2005
Sales	**$ 9,868,449**	$ 5,346,962	**$ 17,015,568**	$ 10,321,569
Cost of sales	**3,734,322**	1,980,007	**6,042,118**	3,675,198
Gross profit	**6,134,127**	3,366,955	**10,973,450**	6,646,371
Operating expenses				
Research and development	**416,886**	185,578	**694,147**	361,187
Selling, general and administrative	**4,260,883**	2,474,606	**8,062,662**	4,936,765
	4,677,769	2,660,184	**8,756,809**	5,297,952
Operating income	**1,456,358**	706,771	**2,216,641**	1,348,419
Other income (expense)				
Interest income	**5,833**		**17,550**	9,718
Interest expense	**(161,980)**	(17,241)	**(197,328)**	(114,552)
Miscellaneous	**(130)**	2,636	**(434)**	
	(156,277)	(14,605)	**(180,212)**	(104,834)
Income before provision for income taxes	**1,300,081**	692,166	**2,036,429**	1,243,585
Provision for income taxes	**442,028**	268,569	**692,387**	448,765
Net income	**$ 858,053**	$ 423,597	**$ 1,344,042**	$ 794,820
Earnings per share:				
Basic	**$ 0.04**	$ 0.12	**$ 0.08**	$ 0.23
Diluted	**$ 0.04**	$ 0.12	**$ 0.08**	$ 0.23
Basic weighted average common shares outstanding	**23,934,251**	3,411,364	**17,196,651**	3,412,614
Diluted weighted average common shares outstanding	**24,148,395**	3,424,045	**17,413,406**	3,425,295

See Notes to Unaudited Condensed, Consolidated Financial Statements.

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Synergetics USA, Inc. and Subsidiaries
Unaudited Condensed Consolidated Statements of Cash Flows
Six Months Ended January 30, 2006 and January 31, 2005

	Six Months Ended January 30, 2006	Six Months Ended January 31, 2005
Cash Flows from Operating Activities		
Net income	$ 1,344,042	$ 794,820
Adjustments to reconcile net income to net cash used in operating activities		
Depreciation and amortization	612,830	486,914
Provision for doubtful accounts receivable	(33,803)	
Stock-based compensation	446,701	
Deferred income tax	(323)	
Change in assets and liabilities:		
(Increase) decrease in:		
Receivables, net	(1,721,668)	(150,207)
Inventories	(2,205,697)	(1,788,450)
Prepaid expenses	(144,719)	116,524
Other current assets	(26,204)	24,675
(Decrease) increase in:		
Accounts payable	672,185	213,288
Other accrued expenses	66,691	(540,477)
Income taxes payable	(48,284)	473,912
Net cash used in operating activities	(1,038,249)	(369,001)
Cash Flows from Investing Activities		
Net decrease in notes receivable, officer-stockholder	7,050	
Purchase of property and equipment	(2,281,779)	(443,145)
Acquisition of patents	(61,060)	(62,303)
Cash paid for reverse merger costs	(515,446)	
Cash acquired through reverse merger	2,023,945	
Purchases of trading securities	(11,000)	
Net cash used in investing activities	(838,290)	(505,448)
Cash Flows from Financing Activities		
Net borrowings on lines-of-credit	387,640	(220,589)
Principal payments on revenue bonds payable	(124,375)	
Proceeds from long-term debt	1,426,952	542,395
Principal payments on long-term debt	(913,698)	(170,610)
Payments on debt incurred for acquisition of trademark	(270,111)	
Proceeds from the exercise of stock options	102,892	
Net cash provided by financing activities	609,300	151,196

Net decrease in cash and cash equivalents		**(1,267,239)**		(723,253)
Cash and cash equivalents				
Beginning		**1,816,823**		1,540,042
Ending	**$**	**549,584**	$	816,789

See Notes to Unaudited Condensed, Consolidated Financial Statements.

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Synergetics USA, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

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 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. The Company is located in O Fallon, Missouri and King of Prussia, Pennsylvania and is engaged in the manufacture and worldwide sale of microsurgical instruments, capital equipment and devices primarily for use in vitreoretinal surgery and neurosurgical applications. During the ordinary course of its business, the Company grants unsecured credit to its domestic and international customers.

Reporting period: The Company s year end is July 31 of each calendar year. For interim periods, the Company uses a 21 business day per month reporting cycle. As such, the information presented in the Form 10-Q is for the three and six month periods October 28, 2005 through January 30, 2006, August 1, 2005 through January 30, 2006, October 29, 2004 through January 31, 2005 and August 1, 2004 through January 31, 2005, respectively. As such, the three month period contains 63 business days and the six month period contains 126 business days.

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 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 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 generally accepted accounting principles 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 and six months ended January 30, 2006 are not necessarily indicative of the results that may be expected for the year ending July 31, 2006. 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, 2005, and notes thereto filed with the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission on October 31, 2005 (the Annual Report).

Note 2. Summary of Significant Accounting Policies

The Company s significant accounting policies are disclosed in the Annual Report. With the exception of the following, the Company s significant accounting policies have not materially changed as of January 30, 2006.

Principles of consolidation: Through the date of the reverse merger described in Note 3, the condensed consolidated financial statements included the accounts of Synergetics and its wholly owned subsidiaries: Synergetics Development Company, LLC and an 83 percent owned subsidiary, Synergetics Laser, LLC. Thereafter, the condensed consolidated financial statements include the accounts of Synergetics USA, Inc. and its wholly owned subsidiaries: Synergetics, Synergetics IP, Inc. and Synergetics Development Company, LLC. All significant intercompany accounts and transactions have been eliminated.

Property and equipment: Leasehold improvements are being amortized over the related lease term or estimated useful lives, whichever is shorter.

Goodwill and other intangibles: Absent any impairment indicators, goodwill is tested for impairment on an annual basis. The Company expects to perform its goodwill impairment tests during the fourth fiscal quarter. Other intangible assets, consisting of patents, licensing agreements and proprietary know-how are amortized to operations under the straight-line method over their estimated useful lives or statutory lives whichever is shorter. These periods range from two to ten years. The life of a trademark is inextricably related to the life of the product bearing the mark or the life of the business entity owning the trademark. The Company intends to use the trademark indefinitely, and therefore, its useful life is not limited to any specific product. The trademark constitutes an indefinite-lived intangible that will be used in perpetuity.

Revenue recognition: The Company records revenue from product sales when the revenue is realized and the product is shipped from its facilities. This includes satisfying the following criteria: the arrangement with the customer is evident, usually through the

receipt of a purchase order; the sales price is fixed and determinable; delivery has occurred; and collectibility is reasonably ensured. Freight and shipping billed to customers is included in net sales, and the cost of shipping is included in cost of sales.

Service revenue substantially relates to repairs of products and is recognized when the service has been completed. Revenue from license and royalty fees is recorded when earned.

Stock-based compensation: As of August 1, 2005, Statement of Financial Accounting Standard (SFAS) No. 123 (Revised 2004), Share-Based Payment (SFAS123(R)), became effective for the Company. The Company had previously followed Accounting Principles Board Opinion No. 25, Accounting for Certain Transactions Involving Stock Compensation (APB No. 25), and related interpretations in accounting for its employee stock options. Under APB No. 25, no compensation expense was recognized, if the exercise price of the Company s employee stock options equaled or exceeded the market price of the underlying stock on the date of the grant. Under SFAS 123(R), compensation expense is now recognized. Stock-based compensation cost is measured at the grant date, based on the fair value of the award and is recognized over the directors and employees requisite service period. Compensation expense is calculated using the Black-Scholes option pricing model. The Company has elected to use the modified prospective transition method. Under the modified prospective transition method, an entity uses the fair values based accounting method for all director and employee awards granted, modified or settled after the effective date. As of the effective date, compensation costs related to the nonvested portion of awards outstanding as of that date are based on the grant-date fair value of those awards as calculated under the original provisions of SFAS 123 Accounting for Stock-Based Compensation ; that is, an entity would not remeasure the grant-date fair value estimate of the unvested portion of awards granted prior to the effective date of SFAS 123(R).

Segment information: The Synergetics segment includes revenue and operating expenses associated with the sales of ophthalmic and neurosurgical instruments and Omni® ultrasonic aspirator. The Valley Forge segment includes revenue and operating expenses associated with the sales of bipolar electrosurgical generators. The financial results of Valley Forge have been included from September 22, 2005 through January 30, 2006.

Note 3. Reverse Merger

On September 21, 2005, Synergetics Acquisition Corporation, a wholly owned subsidiary of Valley Forge, merged with and into Synergetics and Synergetics thereby became a wholly owned subsidiary of Valley Forge. Pursuant to the terms of the merger agreement, stockholders of Synergetics common stock received in the aggregate 15,960,648 shares of Valley Forge common stock, or 4.59 Valley Forge shares for each share of Synergetics resulting in Synergetics former private stockholders owning approximately 66 percent of Valley Forge s outstanding common stock upon completion of the reverse merger. The reverse merger was accounted for as a purchase business combination with Synergetics deemed the accounting acquirer and Valley Forge s assets acquired and liabilities assumed recorded at fair value as follows:

Assets:	
Cash	$ 2,023,945
Accounts receivable	703,119
Inventories	925,489
Prepaid expenses and other current assets	454,451
Property and equipment	323,962
Other intangibles	10,182,533
Goodwill	10,788,565
Liabilities assumed:	
Accounts payable and accrued expenses	(500,869)
Income taxes payable	(35,713)
Note payable issued in connection with Malis® trademark	(3,473,053)
Deferred income taxes	(2,496,022)
Net assets acquired	$ 18,896,407

The operations of Valley Forge have been consolidated from the acquisition date. The cost to acquire Valley Forge has been preliminarily allocated to the Valley Forge assets acquired and liabilities assumed according to their estimated fair values. The preliminary allocation, which includes Synergetics transaction costs, resulted in acquired goodwill of $10,788,565, which is not deductible for tax purposes. The goodwill amount will be adjusted in future periods upon the settlement of certain contingencies which are yet to be finalized.

The unaudited pro forma results, assuming the reverse merger with Valley Forge had occurred at the beginning of each fiscal period presented below, would have yielded the following results:

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	Six Months Ended January 30, 2006	Six Months Ended January 31, 2005 (1)
Net sales	$17,887,629	$12,883,755
Net income	1,178,807	614,865
Basic earnings per share	0.05	0.03
Diluted earnings per share	0.05	0.03

(1) Prior to the reverse merger, Valley Forge had a fiscal year end of September 30 with quarterly results reported on calendar quarters. Accordingly, the unaudited pro forma condensed combined statement of income for the six months ended January 31, 2005 was derived by adding the results of the six months ended January 31, 2005 for Synergetics, Inc. and the results of the six months ended December 31, 2004, for Valley Forge (which was derived by taking the results of the year ended September 30,

2004 less the results of the nine months ended June 30, 2004 plus the results of the three months ended December 31, 2004).

These pro forma results include adjustments to give effect to interest expense of the trademark-related debt and other purchase price adjustments. The pro forma results are not necessarily indicative of the operating results that would have occurred had the reverse merger been consummated as of the beginning of each fiscal period, nor are they necessarily indicative of future operating results.

Note 4. Distribution Agreements

In connection with the reverse merger described in Note 3, the Company became a party to the distribution agreements described below which are in addition to its pre-merger distribution agreements:

Codman and Shurtleff, Inc. (Codman)

In the neurosurgery market, the bipolar electrosurgical system manufactured by Valley Forge prior to the merger has been sold for over 20 years through a series of distribution agreements with Codman, an affiliate of Johnson & Johnson and formerly Valley Forge s largest customer. On October 15, 2004, Valley Forge executed an agreement with Codman for the period October 1, 2004 through December 31, 2005. The agreement provided for exclusive worldwide distribution rights of Valley Forge s existing neurosurgery products in the fields of neurocranial and neurospinal surgery until March 31, 2005, and non-exclusive rights in these fields from April 1, 2005 through December 31, 2005. On May 6, 2005, in accordance with the terms of the agreement, Valley Forge notified Codman that, effective July 15, 2005, Codman would be the non-exclusive worldwide distributor of its existing products in the fields of neurocranial and neurospinal surgery until December 31, 2005. On January 9, 2006, 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. In addition, the Company entered into a new, three-year license agreement, which provides for the continued licensing of Synergetics Malis® trademark to Codman for use with certain Codman products, including those covered by the distribution agreement.

Net sales to Codman amounted to approximately $1,747,000 for the period from September 22, 2005 to January 30, 2006. This represented 10.3 percent of net sales for the six months ended January 30, 2006.

Stryker Corporation (Stryker)

On October 25, 2004, Valley Forge executed a Supply and Distribution Agreement (the Agreement) with Stryker, a Michigan corporation, which provides for the Company to supply to Stryker and for Stryker to distribute exclusively, on a world-wide basis, a unique RF generator for the percutaneous treatment of pain. The Agreement is for a term of five years after the first acceptance of the unique RF generator by Stryker, which was on November 11, 2004.

There is a minimum purchase obligation that is specified by Agreement Year. The first Agreement Year commenced on November 11, 2004 and ended on the last day of the calendar quarter in which the first anniversary date of such inception date occurs, which was December 31, 2005. Stryker satisfied the first Agreement Year minimum. In the second and third Agreement Years, Stryker agreed to make minimum purchases of approximately $500,000 per year for commercial sale units. On or before the beginning of the last calendar quarter of the third Agreement Year, and each Agreement Year thereafter, the Company and Stryker will conduct good faith negotiations regarding the minimum purchase obligation for the next Agreement Year. Also, during the first two months of the last calendar quarter in any Agreement Year, the Company and Stryker will conduct good faith negotiations regarding changes in

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prices that will take effect on the first day of the ensuing Agreement Year. The Agreement also provides Stryker the right of first refusal for other generator products in pain control and in orthopedic, ENT (ear, nose and throat), craniomaxillofacial and head and neck surgery.

Net sales to Stryker amounted to approximately $833,000 for the period from September 22, 2005 to January 30, 2006. This represented 4.9 percent of net sales for the six months ended January 30, 2006.

Note 5. Stock-Based Compensation

In addition to the historical options outstanding for Synergetics prior to the merger, the Company has options outstanding under two existing active option plans and two terminated plans of Valley Forge. The first active plan (the 2001 Plan) was adopted by Valley Forge on January 16, 2001 pursuant to which 345,000 shares of common stock were reserved for issuance to employees, officers and consultants of the Company. The 2001 Plan was amended with the approval of the Valley Forge stockholders on September 19, 2005 to increase the number of share awards issuable under the 2001 Plan from 345,000 to 1,345,000. There were 1,144,125 options unawarded at January 30, 2006. On September 19, 2005, the stockholders of Valley Forge voted to adopt the Valley Forge Scientific Corp. 2005 Non-Employee Directors Stock Option Plan and voted to authorize up to 200,000 shares issuable upon exercise of options granted thereunder. There were 140,000 options available for future grants at January 30, 2006. Generally, options were granted with an exercise price equal to fair market value at the date of grant and expire 10 years from the date of the grant. Generally, stock options granted vest over a five year period with the exception of the Non-Employee Director options which vest immediately. All options under the Valley Forge stock option plans were valued at approximately $815,000 in the purchase price accounting allocation.

The following table shows activity under the Company s plans for the six months ended January 30, 2006:

	Six Months Ended January 30, 2006		
	Shares	Weighted-Average Exercise Price	Weighted-Average Fair Value
Options outstanding, beginning of period	58,500	$ 2.33	$ 2.97
Exercised prior to September 21, 2005	(20,500)		$ 3.92
Options outstanding, September 21, 2005	38,000	$ 4.64	$ 2.46
Conversion ratio applied at September 21, 2005	4.59	4.59	
Converted options	174,420	$ 1.01	$ 2.46
Existing options assumed under the Valley Forge Stock option plan	441,500	$ 2.18	$ 1.92
For the period from September 22, 2005 through January 30, 2006:			
Granted	20,000	$ 5.00	$ 4.15
Forfeited			
Exercised	(48,500)	$ 2.12	$ 1.86
Options outstanding, end of period	587,420	$ 1.94	$ 1.62
Options exercisable end of period	474,965	$ 2.14	$ 1.79

The following table provides information about unvested options for the six months ended January 30, 2006:

	Shares	Weighted Average Grant Date Value

Unvested options, beginning of period	36,834	$	3.42
Vested upon change of control	11,334	$	4.00
Unvested options outstanding September 21, 2005	25,500	$	3.16
Conversion ratio applied at September 21, 2005	4.59		
Converted options	117,045	$	0.90
From September 22, 2005 through January 30, 2006:			
Vested	4,590	$	0.72
Unvested options, period end	112,455	$	0.91

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Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised were as follows:

	Three Months Ended January	
	2006	2005
Proceeds of options exercised	$ 95,437	$ 0
Related tax benefit recognized	$ 34,718	$ 0
Intrinsic value of options exercised	$ 85,680	$ 0

	Six Months Ended January	
	2006	2005
Proceeds of options exercised	$ 102,892	$ 0
Related tax benefit recognized	$ 37,758	$ 0
Intrinsic value of options exercised	$ 89,145	$ 0

The following table provides information about options outstanding and exercisable options at January 30, 2006:

	Options Outstanding	Exercisable Options
Number	587,420	474,965
Weighted average exercise price	$ 1.94	$ 2.14
Aggregate intrinsic value	$ 951,719	$ 849,385
Weighted average contractual term	7 years	6.5 years

The weighted average remaining life for options outstanding and weighted average exercise price per share for exercisable options at January 30, 2006 were as follows:

	Options Outstanding		Exercisable Options	
	Shares	Weighted Average Remaining Contractual Life (in Years)	Shares	Weighted Average Remaining Contractual Life (in Years)
< $1.00	61,965	4.1 years	61,965	