HESKA CORP
Form 10-Q
August 14, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

OR

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: 000-22427

HESKA CORPORATION
(Exact name of registrant as specified in its charter)

Delaware	77-0192527
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
3760 Rocky Mountain Avenue Loveland, Colorado	80538
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (970) 493-7272

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

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 x 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 as defined in Rule 12b-2 of the Exchange Act. 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 small reporting company)	Smaller reporting company x

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

The number of shares of the Registrant's Public Common Stock outstanding at August 13, 2013 was 5,826,079.

TABLE OF CONTENTS

HESKA, ALLERCEPT, AVERT, E-SCREEN, FELINE ULTRANASAL, HEMATRUE, SOLO STEP, THYROMED, VET/OX and VITALPATH are registered trademarks and CBC-DIFF, ELEMENT DC and VET/IV are trademarks of Heska Corporation. TRI-HEART is a registered trademark of Schering-Plough Animal Health Corporation ("SPAH") in the United States and is a registered trademark of Heska Corporation in other countries. DRI-CHEM is a registered trademark of FUJIFILM Corporation. This Form 10-Q also refers to trademarks and trade names of other organizations.

HESKA CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(amounts in thousands except shares and per share amounts)
(unaudited)

ASSETS

	December 31, 2012	June 30, 2013
Current assets:		
Cash and cash equivalents	$ 5,784	$ 5,410
Accounts receivable, net of allowance for doubtful accounts of $155 and $214, respectively	11,044	8,393
Inventories, net	12,483	14,300
Deferred tax asset, current	1,130	238
Other current assets	2,514	1,055
Total current assets	32,955	29,396
Property and equipment, net	6,005	7,044
Note receivable – related party	—	1,379
Goodwill and other intangible assets	1,120	21,641
Deferred tax asset, net of current portion	26,746	29,215
Other long-term assets	—	70
Total assets	$ 66,826	$ 88,745
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 5,298	$ 5,721
Accrued liabilities	4,132	4,882
Current portion of deferred revenue	2,407	3,644
Line of credit	2,552	1,991
Other short-term borrowings, including current portion of long-term note payable	—	986
Total current liabilities	14,389	17,224
Long-term note payable, net of current portion	—	435
Deferred revenue, net of current portion, and other	3,575	9,405
Total liabilities	17,964	27,064
Commitments and contingencies		
Non-Controlling Interest	—	12,551
Public Common Stock subject to redemption	—	2,888
Stockholders' equity:		
Preferred stock, $.01 par value, 2,500,000 shares authorized; none issued or outstanding	—	—
	—	—

Common stock, $.01 par value, 7,500,000 shares authorized; none issued or outstanding				
Public common stock, $.01 par value, 7,500,000 shares authorized, 5,372,336 and 5,811,889 shares issued and outstanding, respectively		54		58
Additional paid-in capital		218,544		219,578
Accumulated other comprehensive income		296		216
Accumulated deficit		(170,032)		(173,610)
Total stockholders' equity		48,862		46,242
Total liabilities and stockholders' equity	$	66,826	$	88,745

See accompanying notes to condensed consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended June 30, 2012	Three Months Ended June 30, 2013	Six Months Ended June 30, 2012	Six Months Ended June 30, 2013
Revenue, net				
Core companion animal health	$ 15,701	$ 15,851	$ 32,281	$ 31,500
Other vaccines, pharmaceuticals and products	2,570	2,410	5,165	5,740
Total revenue, net	18,271	18,261	37,446	37,240
Cost of revenue	10,223	13,241	20,475	24,418
Gross profit	8,048	5,020	16,971	12,822
Operating expenses:				
Selling and marketing	4,751	4,838	9,639	9,963
Research and development	203	483	537	873
General and administrative	2,711	3,277	5,330	6,246
Total operating expenses	7,665	8,598	15,506	17,082
Operating income (loss)	383	(3,578)	1,465	(4,260)
Interest and other (income) expense, net	(57)	52	85	41
Income (loss) before income taxes	440	(3,630)	1,380	(4,301)
Income tax expense (benefit):				
Current tax expense	34	59	82	65
Deferred tax expense (benefit)	144	(1,222)	452	(1,547)
Total income tax expense (benefit)	178	(1,163)	534	(1,482)
Net income (loss)	$ 262	$ (2,467)	$ 846	$ (2,819)
Net income (loss) attributable to non-controlling interest	—	(239)	—	(205)
Net income (loss) attributable to Heska Corporation	$ 262	$ (2,228)	$ 846	$ (2,614)
Basic net income (loss) per share attributable to Heska Corporation	$ 0.05	$ (0.38)	$ 0.16	$ (0.46)
Diluted net income (loss) per share attributable to Heska Corporation	$ 0.05	$ (0.38)	$ 0.15	$ (0.46)
Weighted average outstanding shares used to compute basic net income (loss) per share attributable to Heska Corporation	5,327	5,804	5,296	5,676
Weighted average outstanding shares used to compute diluted net income (loss) per share attributable to Heska Corporation	5,583	5,804	5,517	5,676

See accompanying notes to condensed consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(unaudited)

	Three Months Ended June 30		Six Months Ended June 30,	
	2012	2013	2012	2013
Net income (loss)	$ 262	$ (2,467)	$ 846	$ (2,819)
Other comprehensive income (expense):				
Foreign currency translation	(144)	13	(36)	(94)
Unrealized gain on available for sale investments	—	13	—	13
Comprehensive income (loss)	$ 118	$ (2,441)	$ 810	$ (2,900)
Comprehensive income (loss) attributable to non-controlling interest	$ —	$ (239)	$ —	$ (205)
Comprehensive income (loss) attributable to Heska Corporation	$ 118	$ (2,202)	$ 810	$ (2,695)

See accompanying notes to condensed consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2013
CASH FLOWS PROVIDED BY (USED IN) OPERATING ACTIVITIES:		
Net income (loss)	$ 846	$ (2,819)
Adjustments to reconcile net income to cash provided by (used in) operating activities:		
Depreciation and amortization	861	1,089
Deferred tax expense (benefit)	452	(1,547)
Stock-based compensation	181	231
Unrealized (gain) loss on foreign currency translation	(19)	(24)
Changes in operating assets and liabilities:		
Accounts receivable	(161)	3,157
Inventories	72	(1,143)
Other current assets	(379)	577
Other non-current assets	(92)	—
Accounts payable	(108)	(1,000)
Accrued liabilities	440	518
Deferred revenue and other liabilities	(23)	(102)
Net cash provided by (used in) operating activities	2,070	(1,063)
CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES:		
Investment in subsidiary	—	(3,019)
Purchase of property and equipment	(542)	(734)
Proceeds from disposition of property and equipment	—	5,020
Net cash provided by (used in) investing activities	(542)	1,267
CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES:		
Proceeds from issuance of common stock	295	111
Proceeds from (repayments of) line of credit borrowings, net	—	(561)
Proceeds from (repayments of) other debt	—	(105)
Dividends to shareholders	(532)	—
Net cash provided by (used in) financing activities	(237)	(555)
EFFECT OF EXCHANGE RATE CHANGES ON CASH	1	(23)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,292	(374)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	6,332	5,784
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 7,624	$ 5,410
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Dividends payable	$ 534	$ —
Cash paid for interest	$ 56	$ 43
Non-cash transfer of inventory to property and equipment	$ 639	$ 787
Prepaid applied to acquisition of Heska Imaging	$ —	$ 1,000

See accompanying notes to condensed consolidated financial statements.

HESKA CORPORATION AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2013
(UNAUDITED)

1. ORGANIZATION AND BUSINESS

Heska Corporation ("Heska" or the "Company") develops, manufactures, markets, sells and supports veterinary products. Heska's core focus is on the canine and feline companion animal health markets.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements are the responsibility of the Company's management and have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the instructions to Form 10-Q and rules and regulations of the Securities and Exchange Commission (the "SEC"). The condensed consolidated balance sheet as of June 30, 2013, the condensed consolidated statements of operations for the three months and six months ended June 30, 2012 and 2013, the condensed consolidated statements of comprehensive income for the three months and six months ended June 30, 2012 and 2013 and the condensed consolidated statements of cash flows for the six months ended June 30, 2012 and 2013 are unaudited, but include, in the opinion of management, all adjustments (consisting of normal recurring adjustments) which the Company considers necessary for a fair presentation of its financial position, operating results and cash flows for the periods presented. All material intercompany transactions and balances have been eliminated in consolidation. Although the Company believes that the disclosures in these financial statements are adequate to make the information presented not misleading, certain information and footnote disclosures normally included in complete financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the SEC.

Results for any interim period are not necessarily indicative of results for any future interim period or for the entire year. The accompanying financial statements and related disclosures have been prepared with the presumption that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year. Accordingly, these financial statements should be read in conjunction with the audited financial statements and the related notes thereto for the year ended December 31, 2012, included in the Company's Annual Report on Form 10-K filed with the SEC on March 14, 2013.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenue and expense during the reported period. Actual results could differ from those estimates. Significant estimates are required when establishing the allowance for doubtful accounts and the provision for excess/obsolete inventory, in determining the period over which the Company's obligations are fulfilled under agreements to license product rights and/or technology rights, in determining the need for, and the amount of, a valuation allowance on certain deferred tax assets and in determining the need for, and the amount of, an accrued liability for future payments related to minimum purchase obligations the Company may make in order to maintain certain product rights.

Inventories

Inventories are stated at the lower of cost or market using the first-in, first-out method. Inventory manufactured by the Company includes the cost of material, labor and overhead. If the cost of inventories exceeds estimated fair value, provisions are made to reduce the carrying value to estimated fair value.

Inventories, net consist of the following (in thousands):

	December 31, 2012	June 30, 2013
Raw materials	$ 5,275	$ 5,711
Work in process	3,342	2,548
Finished goods	4,671	7,797
Allowance for excess or obsolete inventory	(805)	(1,756)
	$ 12,483	$ 14,300

Basic and Diluted Net Income (Loss) Per Share

Basic net income (loss) per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed using the sum of the weighted average number of shares of common stock outstanding, and, if not anti-dilutive, the effect of outstanding common stock equivalents (such as stock options and warrants) determined using the treasury stock method. For the three and six months ended June 30, 2012, the Company reported net income and therefore, dilutive common stock equivalent securities, as computed using the treasury method, were added to basic weighted average shares outstanding for the period to derive the weighted average shares for diluted earnings per share calculation. Common stock equivalent securities that were anti-dilutive for the three and six months ended June 30, 2012, and therefore excluded, were outstanding options to purchase 510,770 and 538,941 shares of common stock, respectively. These securities are anti-dilutive primarily due to exercise prices greater than the average trading price of the Company's common stock during the three and six months ended June 30, 2012. For the three and six months ended June 30, 2013, the Company reported a net loss and therefore all common stock equivalent securities would be anti-dilutive and were not included in the diluted earnings per share calculation for the period. Common stock equivalent securities that were anti-dilutive for the three months and six months ended June 30, 2013, and therefore excluded, were outstanding options to purchase 1,177,736 and 1,206,864 shares of common stock, respectively. These securities are anti-dilutive due to the Company’s net loss for the three and six months ended June 30, 2013.

3. ACQUISITION

Cuattro Veterinary USA, LLC

On February 24, 2013, the Company acquired a 54.6% interest in Cuattro Veterinary USA, LLC ("Cuattro Vet USA") for approximately $7.6 million in cash and stock, including more than $4 million in cash (the "Acquisition"). Immediately following and as a result of the transaction, former Cuattro Vet USA unit holders owned approximately 7.2% of the Company's Public Common Stock. The remaining minority position (45.4%) in Cuattro Vet USA is subject to purchase by Heska under performance-based puts and calls following calendar year 2015, 2016 and 2017. Since the exercise of any put option is out of the Company’s control, authoritative guidance requires the non-controlling interest, which includes the value of the put option, to be displayed outside of the equity section of the Company’s consolidated balance sheet. Should Heska undergo a change in control, as defined, prior to the end of

2017, Cuattro Vet USA minority unit holders will be entitled to sell their Cuattro Vet USA units to Heska at the highest call value they could have otherwise obtained. The Company's position in Cuattro Vet USA is subject to premium repurchase or discounted sale under calls and puts expiring 18 months following the closing of the transaction.

Cuattro Vet USA was subsequently renamed Heska Imaging US, LLC ("Heska Imaging") and markets, sells and supports digital radiography and ultrasound products along with embedded software and support, data hosting and other services.

Shawna M. Wilson, Clint Roth, DVM, Steven M. Asakowicz, Rodney A. Lippincott, Kevin S. Wilson and Cuattro, LLC own approximately 29.75%, 8.39%, 4.09%, 3.07%, 0.05% and 0.05% of Heska Imaging, respectively. Kevin S. Wilson is the President and Chief Operating Officer of the Company and the spouse of Shawna M. Wilson. Steven M. Asakowicz serves as Executive Vice President, Companion Animal Health Sales for the Company. Rodney A. Lippincott serves as Executive Vice President, Companion Animal Health Sales for the Company. Mr. Wilson, Mrs. Wilson and trusts for their children and family own a 100% interest in Cuattro, LLC.

The aggregate position in Heska Imaging of the unit holders who hold the 45.4% of Heska Imaging that Heska Corporation does not own (the "Put Value") is being accreted to its estimated redemption value in accordance with Heska Imaging's Operating Agreement. The adjustment to increase or decrease the Put Value to its expected redemption value each reporting period is recorded to retained earnings in accordance with United States Generally Accepted Accounting Principles.

The Company accounted for the acquisition pursuant to ASC No. 805, "Business Combinations." Accordingly, it recorded assets acquired, liabilities assumed and non-controlling interests at their fair values. The following summarizes the aggregate consideration paid by the Company and the allocation of the purchase price based on current estimates as the Company continues to gather information to evaluate the appropriate accounting result (in thousands):

Consideration	
Cash	$ 4,073
Stock	3,571
Total	$ 7,644

Inventories	$ 1,466
Note from Cuattro Veterinary, LLC, due March 15, 2016	1,360
Other tangible assets	1,278
Intangible assets	688
Goodwill	19,994
Notes payable and other borrowings	(1,527)
Accounts payable	(1,424)
Other assumed liabilities	(2,399)
	$ 19,436
Non-controlling interest	(11,792)
Total	$ 7,644

Intangible assets and their amortization periods are as follows:

	Useful Life (in years)	Fair Value
Trade name	2.75	$ 688
		$ 688

Cuattro Vet USA generated net revenue of $4.6 million and net loss of $450 thousand, inclusive of net loss of $205 thousand attributable to non-controlling interest, for the period from February 24, 2013 to June 30, 2013. The following unaudited pro forma financial information presents the combined results of the Company and Cuattro Vet USA as if the Acquisition had closed on January 1, 2012.

	Six Months Ended June 30,	
	2012	2013
Revenue, net	$ 40,951	$ 38,140
Net income (loss) attributable to Heska Corporation	535	(3,010)
Basic earnings (loss) per share attributable to Heska Corporation	$ 0.09	$ (0.53)
Diluted earnings (loss) per share attributable to Heska Corporation	0.09	(0.53)

4. CAPITAL STOCK

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model, with the following weighted average assumptions for options granted in the three and six months ended June 30, 2012 and 2013.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2013	2012	2013
Risk-free interest rate	0.35%	0.46%	0.37%	0.50%
Expected lives	2.8 years	3.4 years	2.8 years	3.4 years
Expected volatility	65%	52%	65%	52%
Expected dividend yield	3.23%	0%	3.25%	0%

A summary of the Company's stock option plans, excluding options to purchase fractional shares resulting from the Company's December 2010 1-for-10 reverse stock split is as follows:

	Year Ended December 31, 2012		Six Months Ended June 30, 2013	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Outstanding at beginning of period	1,448,675	$ 10.425	1,245,161	$ 11.054
Granted at market	137,950	$ 9.534	60,730	$ 8.337
Cancelled	(118,330)	$ 11.373	(153,810)	$ 11.383
Exercised	(223,134)	$ 5.863	(19,107)	$ 6.286
Outstanding at end of period	1,245,161	$ 11.054	1,132,974	$ 10.944

Exercisable at end of period	971,029	$ 12.129	911,549	$ 11.761

The estimated fair value of stock options granted during the six months ended June 30, 2013 and 2012 was computed to be approximately $506 thousand and $155 thousand, respectively. The amount is amortized ratably over the vesting period of the options. The per share weighted average estimated fair value of options granted during the six months ended June 30, 2013 and 2012 was computed to be approximately $3.12 and $4.40, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2013 and 2012 was approximately $30 thousand and $990 thousand, respectively. The cash proceeds from options exercised during the six months ended June 30, 2013 and 2012 were approximately $66 thousand and $231 thousand, respectively.

The following table summarizes information about stock options outstanding and exercisable at June 30, 2013, excluding outstanding options to purchase an aggregate of 81.6 fractional shares resulting from the Company's December 2010 1-for-10 reverse stock split with a weighted average remaining contractual life of 1.69 years, a weighted average exercise price of $14.41 and exercise prices ranging from $4.40 to $31.50. The Company intends to issue whole shares only from option exercises.

	Options Outstanding			Options Exercisable	
Exercise Prices	Number of Options Outstanding at June 30, 2013	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number of Options Exercisable at June 30, 2013	Weighted Average Exercise Price
$ 2.70 - $ 6.76	238,489	5.58	$ 5.112	201,328	$ 5.120
$ 6.77 - $ 8.55	276,232	8.16	$ 7.875	104,202	$ 7.723
$ 8.56 - $12.40					