REHABILICARE INC
Form 10-Q
November 14, 2001

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 September 30, 2001

OR

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

For the transition period from __________________ to ______________.

Commission File No. 0-9407

REHABILICARE INC.
(Exact name of registrant as specified in its charter)

MINNESOTA	41-0985318
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1811 OLD HIGHWAY 8
NEW BRIGHTON, MINNESOTA 55112
(Address of principal executive offices)

(651) 631-0590
(Registrant's telephone number, including area code)

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 [ ]

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of November 9, 2001 was:

COMMON STOCK, $.10 PAR VALUE	10,815,945 SHARES

CAUTIONARY STATEMENT REGARDING FORWARD LOOKING STATEMENTS

The following Quarterly Report on Form 10-Q contains various "forward looking statements" within the meaning of federal securities laws. These forward looking statements represent management's expectations or beliefs concerning future events, including statements regarding anticipated product introductions; changes in markets, customers and customer order rates; changes in third party reimbursement rates; expenditures for research and development; growth in revenue; taxation levels; and the effects of pricing decisions. When used in this 10-Q, the words "anticipate," "believe," "expect," "estimate" and similar expressions are generally intended to identify forward-looking statements. These and other forward looking statements made by the Company must be evaluated in the context of a number of factors that may affect the Company's financial condition and results of operations, including, but not limited to, the following:

- Like many medical device companies, the Company has a large balance of uncollected receivables. If it cannot collect an amount of receivables that is consistent with historical collections, it might be required to charge off a portion of uncollected receivables, significantly impacting earnings.

- In the United States the Company's products are subject to reimbursement by private and public healthcare reimbursement agencies that impose limits on reimbursement and strict rules on applications for reimbursement. Changes in the rates, eligibility or requirements for reimbursement, or failure to comply with reimbursement requirements, could cause a reduction in earnings or fines or both.

- The Company maintains significant amounts of inventory on consignment at clinics and for distribution to patients. It may not be able to completely control losses of this inventory and if inventory losses are not consistent with historical experience, it might be required to write off a portion of the carrying value of inventory.

- The clinical effectiveness of the Company's electrotherapy products has periodically been challenged. Publicity about the effectiveness of electrotherapy for pain relief or other clinical applications could negatively impact sales and earnings.

- The Company formed a U.K. subsidiary in fiscal 1999 and acquired a Swiss company in the first quarter of fiscal 2000. These European operations may be more difficult to supervise, may be subject to different economic influences than United States operations, and may subject us to significant exposure from currency fluctuations.

- The Company has periodically been the subject of litigation that has caused it additional expense, including a Medicare whistleblower suit settled in 2000 for approximately $1.6 million and, currently, a $2.3 million product liability suit that proceeded to a default judgment without the Company's knowledge. The costs of these actions, and other actions that may arise, have negatively affected, and may continue to negatively affect, the Company operating results.

- Portions of the Company's operations, and particularly its European operations directed to the sports consumer markets, are subject to competition on the basis of price and customer loyalty. As these consumer products become more widely used, the margins commanded by the products may decline.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Included herein is the following unaudited condensed financial information:

Consolidated Balance Sheets as of September 30, 2001 and June 30, 2001

Consolidated Statements of Operations for the three months ended September 30, 2001 and 2000

Consolidated Statements of Cash Flows for the three months ended September 30, 2001 and 2000

Notes to Consolidated Financial Statements

REHABILICARE INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	SEPTEMBER 30, 2001	JUNE 30, 2001
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 2,945,540	$ 759,611
Receivables, less reserve for uncollectible accounts of $8,319,351 and $8,062,378	18,118,791	18,998,132
Inventories -		
Raw materials	2,386,354	2,039,665
Work in process	96,624	55,895
Finished goods	7,059,892	6,552,155
Deferred tax assets	4,075,317	4,075,317
Prepaid expenses	2,220,083	2,156,646
Total current assets	36,902,601	34,637,421
Property, plant and equipment, net	4,909,072	5,025,969
Intangible assets, net	11,184,006	11,250,761
Deferred tax assets	487,358	460,985
Other assets	132,622	120,735
	$53,615,659	$51,495,871

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:		
Note payable	$ 2,050,000	$ --
Current maturities of long-term debt	2,420,606	2,430,173
Accounts payable	3,596,252	3,977,308
Accrued liabilities -		
Payroll	246,927	787,314
Commissions	294,345	338,491
Income taxes	1,923,718	1,631,710
Other	2,684,959	3,080,551
Total current liabilities	13,216,807	12,245,547
Long-Term Liabilities:		
Long term-debt	9,848,158	10,433,542
Deferred tax liabilities	394,898	357,566
Total liabilities	23,459,863	23,036,655
Stockholders' Equity:		
Common stock, $.10 par value: 25,000,000 shares authorized; issued and outstanding 10,815,945 and 10,792,060 shares, respectively	1,081,594	1,079,206
Preferred stock, no par value; 5,000,000 shares authorized; none issued and outstanding	--	--
Additional paid-in capital	21,468,865	21,420,378
Less note receivable from officer/stockholder	(189,417)	(189,417)
Unearned compensation on restricted stock	(159,375)	(186,563)
Accumulated other non-owner changes in equity	(261,965)	(689,459)
Retained earnings	8,216,094	7,025,071
Total stockholders' equity	30,155,796	28,459,216
	$53,615,659	$51,495,871

REHABILICARE INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30	
	2001	2000
Net sales and rental revenue	$16,098,728	$15,067,647
Cost of sales and rentals	5,147,475	4,749,840
Gross profit	10,951,253	10,317,807

Operating expenses:		
Selling, general and administrative	8,024,284	7,685,140
Research and development	642,306	358,343
Total operating expenses	8,666,590	8,043,483
Income from operations	2,284,663	2,274,324
Other income (expense):		
Interest expense	(235,151)	(406,886)
Other	4,511	8,740
Income before income taxes	2,054,023	1,876,178
Income tax provision	863,000	754,000
Net income	$ 1,191,023	$ 1,122,178
Net income per common and common equivalent share		
Basic	$ 0.11	$ 0.10
Diluted	$ 0.11	$ 0.10
Weighted average number of shares outstanding		
Basic	10,815,945	10,723,237
Diluted	10,865,319	10,750,591

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REHABILICARE INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30	
	2001	2000
Operating Activities:		
Net income	$1,191,023	$ 1,122,178
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	403,092	671,113
Amortization of unearned compensation	27,188	--

Change in long-term portion of deferred taxes	10,952	(299)
Change in current assets and liabilities -		
Receivables	1,205,160	1,391,933
Inventories	(639,823)	199,065
Prepaid expenses	102,396	(1,017,073)
Accounts payable	(690,893)	(756,907)
Accrued liabilities	(846,794)	(594,141)
Net cash provided by operating activities	762,301	1,015,869
Investing Activities:		
Purchases of property and equipment	(129,539)	(324,663)
Change in other assets, net	840	52,455
Net cash used in investing activities	(128,699)	(272,208)
Financing Activities:		
Principal payments on long-term obligations	(594,951)	(540,166)
Proceeds from (payments on) line of credit, net	2,050,000	(1,200,000)
Proceeds from exercise of stock options	--	455,000
Proceeds from employee stock purchase plan	50,875	59,656
Net cash provided by (used in) financing activities	1,505,924	(1,225,510)
Effect of exchange rates on cash and cash equivalents	46,403	(183,173)
Net increase (decrease) in cash and cash equivalents	2,185,929	(665,022)
Cash and Cash Equivalents at Beginning of Period	759,611	2,227,352
Cash and Cash Equivalents at End of Period	$2,945,540	$ 1,562,330
Supplemental Cash Flow Information:		
Interest paid	$ 235,151	$ 378,886
Income taxes paid	$ 603,000	$ 846,500

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REHABILICARE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2001

1. Accounting Policies

The amounts set forth in the preceding financial statements are unaudited as of and for the periods ended September 30, 2001 and 2000 but, in the opinion of management, reflect all adjustments (consisting only of normal recurring adjustments) necessary for a fair statement of the results for the periods presented. Such results are not necessarily indicative of results for the full year. The accompanying financial statements of the Company should be read in conjunction with the audited consolidated financial statements for the year ended June 30, 2001 included in the Company's Annual Report on Form 10-K.

Certain previously reported amounts have been reclassified to conform to classifications adopted in fiscal year 2001. These reclassifications had no effect on net income, cash flows or shareholders' equity.

2. Recently Issued Accounting Standards

In July 2001, the FASB issued Statements of Financial Accounting Standards No. 141, "Business Combinations" and No. 142, "Goodwill and Other Intangible Assets". These standards change the accounting for business combinations by, among other things, prohibiting the prospective use of pooling-of-interests accounting and requiring companies to stop amortizing goodwill and certain intangible assets with an indefinite useful life created by business combinations accounted for using the purchase method of accounting. Instead, goodwill and intangible assets deemed to have an indefinite useful life will be subject to an annual review for impairment. The Company adopted the standards in the first quarter of 2002. The impact of adopting the standards and stopping the amortization of goodwill resulted in a decrease of amortization expense of approximately $210,000 in the first quarter of fiscal 2002.

3. Note Payable and Long Term Debt

The Company has a $20,000,000 credit facility which provides for both term and revolving borrowings at varying rates based either on the bank's prime rate or LIBOR. As of September 30, 2001, there were borrowings outstanding of $10,297,000 on the long-term note and $2,050,000 on the revolving credit line.

Borrowings under the credit facility are secured by substantially all assets of the Company other than those pledged as collateral on existing lease or mortgage obligations. The interest rate on the term loan was 5.81% at September 30, 2001 and the weighted average rate on borrowings under the revolving line of credit was 6.54%.

The Company was in compliance with all financial covenants in its credit agreement as of September 30, 2001 and for the period then ended.

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4. Segment Information

Rehabilicare and its consolidated subsidiaries operate in one reportable segment, the manufacture and distribution of electromedical pain management and rehabilitation products. The Company's chief operating decision makers use consolidated results to make operating and strategic decisions. Net revenue from the United States and foreign sources (primarily Europe) are as follows:

	FOR THE THREE MONTHS ENDED SEPTEMBER 30	
	2001	2000

U.S. revenue	$11,098,280	$10,779,192
Foreign revenue	5,000,448	4,288,455
	$16,098,728	$15,067,647

Net revenue by product line was as follows:

	FOR THE THREE MONTHS ENDED SEPTEMBER 30	
	2001	2000
Rehabilitation products	$ 3,292,010	$ 3,259,563
Pain management	3,375,808	3,241,264
Consumer Products	3,750,920	3,158,687
Accessories and supplies	5,679,990	5,408,133
	$16,098,728	$15,067,647

During the first quarter of fiscal 2002, one customer accounted for approximately 16% of total consolidated revenue. This customer represented approximately 1% of total accounts receivable at September 30, 2001.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

The Company designs, manufactures and distributes electrotherapy products used for pain management, rehabilitation and sports training. Its products are used in clinical, home health care, sports medicine and occupational medicine applications. It also distributes other medical products used in related applications. The Company operates in one business segment, distributing its products through sales to medical product dealers and distributors, sport shops and, in the United States, through direct rental or sale to patients.

The direct rental or sale approach involves placing electrotherapy units with physicians, physical therapists and other health care providers who then refer those units to patients after determining an appropriate treatment regimen. Units are left on consignment with the health care providers for such referral. The Company then bills the patient or the patient's insurance carrier directly after being notified that a unit has been prescribed and provided to the patient. The Company takes responsibility for subsequent patient follow-up, including extension of the rental period, sale of the unit, if appropriate, and sale of additional supplies required for continued use of the electrotherapy units. This distribution approach requires the Company to maintain significant investments in inventories and receivables.

RESULTS OF OPERATIONS

The following table sets forth information from the statements of operations as a percentage of revenue for the periods indicated:

	THREE MONTHS ENDED SEPTEMBER 30	
	2001	2000
Net sales and rental revenue	100.0%	100.0%
Cost of sales and rentals	32.0	31.5
Gross profit	68.0	68.5
Operating expenses -		
Selling, general and administrative	49.8	51.0
Research and development	4.0	2.4
Total operating expenses	53.8	53.4
Income from operations	14.2	15.1
Other expense, net	1.4	2.7
Gain on sale of building	--	--
Income tax provision	5.4	5.0
Net income	7.4	7.4

Revenue was $16,099,000 for the first quarter of fiscal 2002, a 7% increase from $15,068,000 for the first quarter of fiscal 2001. The increase was primarily attributable to the Company's Compex operation where revenue increased 17% from $4,033,000 in the first quarter of fiscal 2001, to $4,718,000 in the first quarter of fiscal 2002. Compex's revenue increase resulted from the strengthening of European currencies against the U.S. dollar and higher orders for a new product that was released in the fourth quarter of fiscal 2001. Compex sales quarter to quarter were down slightly due to the usual slow down in European business during the summer months. Revenue from U.S. operations was up slightly from increased volume in its direct distribution business.

Gross profit was $10,951,000 or 68.0% of revenue in the first quarter of fiscal 2002 compared with $10,318,000 or 68.5% of revenue in the first quarter of fiscal 2001. The slight drop in the gross margin percentage resulted primarily from the continued focus on sales of Compex sport products at wholesale prices to retail store outlets rather than direct to consumers at retail prices. This change in strategy is expected to expand market penetration, but will also likely result in lower overall consolidated margins in fiscal 2002.

Selling general and administrative expenses increased 4% to $8,024,000 in the first quarter of fiscal 2002 from $7,685,000 in the first quarter of fiscal 2001. As a percent of revenue, those expenses declined to

50% in the first quarter of fiscal 2002 from 51% in fiscal 2001. Several factors contributed to the decrease. The first quarter of fiscal 2002 does not include approximately $210,000 of goodwill amortization due to the adoption of the previously discussed Financial Accounting Standards. Also, reductions as a percent of revenue reflect lower selling expenses related to the Compex retail sales strategy and certain economies of scale.

Research and development expenses increased 79% to $642,000 in the first quarter of fiscal 2002 compared to $358,000 during the same period in fiscal 2001. This increase reflects expanded new product development activities both in the U.S., particularly related to the ProMax product which started production in October 2001, and in Europe where three new products have been introduced in the last six months and a fourth new product will be introduced later in fiscal 2002. The Company anticipates that research and development expenses will remain relatively constant as a percentage of revenue in future periods.

Interest expense decreased 42% from $407,000 in the first quarter of fiscal 2001, to $235,000 during the same period of fiscal 2002. The decrease resulted from lower interest rates and overall lower borrowings on the Company's credit facility. The Company expects interest expense to continue to decline with the lower overall balance of its indebtedness and lower interest rates in future periods.

The provision for income taxes is 42% of income before taxes in the first quarter of fiscal 2002 compared to 40% during the same period of fiscal 2001. The Company now operates in various countries in Europe as well as the United States. Some countries have higher tax rates than the United States as well as different rules on the deductibility of certain expenses and the availability of certain credits for taxes paid to other jurisdictions. The Company believes that 42% is a reasonable estimate of the effective rate for fiscal 2002 based on most recent estimates of expected sources of revenue and expenses for the entire year. The Company's federal income taxes for the years ended June 30, 1997 and 1998 were recently audited. The Internal Revenue Service has proposed adjustments pursuant to such audit, most of which relate to the timing of revenue or expense recognition. The Company is contesting these adjustments and believes its provision for income taxes and related reserves are adequate.

As a result of the above activity, net income increased from $1,122,000 in the first quarter of fiscal 2001 to $1,191, 000 in the first quarter of fiscal 2002. Diluted earnings per share increased from $.10 in the first quarter of fiscal 2001 to $.11 in the first quarter of fiscal 2002.

LIQUIDITY AND CAPITAL RESOURCES

During the quarter ended September 30, 2001, the Company's operations provided cash of $762,000, mainly from net income of $1,191,000 and a reduction in accounts receivable of $1,205,000, offset by an increase in inventories of $640,000 and decreases of $691,000 in accounts payable and $847,000 in accrued liabilities.

The Company used $129,000 in investing activities in the first quarter of fiscal 2002 for net purchases of property and equipment.

The Company's financing activities provided $1,506,000 of cash during the first quarter of fiscal 2002, mainly from borrowings under its $20,000,000 credit facility less $595,000 that was used for repayment of

debt. Borrowings were used primarily to build inventories in connection with new product introductions. At September 30, 2001, a total of $12,850,000 is outstanding under this facility, which includes $10,297,000 under a long-term note and $2,050,000 on the revolving line of credit.

Managing receivables represents one of the biggest business challenges to the Company. The process of determining what products will be reimbursed by third party payors and the amounts to be paid for those products is very complex and the reimbursement environment is constantly changing. That risk is spread across many payors throughout the United States. The determination of an appropriate reserve for uncollectable accounts at the end of each reporting period includes various factors including historical trends and relationships and experience with insurance companies or other third party payors. The Company believes that the reserve at September 30, 2001 is adequate to cover future losses on its receivables based on collection history and trends. The provision for uncollectable accounts recorded in the income statement may continue to fluctuate significantly from quarter to quarter as such trends change. The reserve was 31.4% of receivables at September 30, 2001 compared to 29.8% at June 30, 2001.

The Company has no material commitment for capital expenditures. The Company believes that available cash and borrowings under its credit line will be adequate to fund cash requirements for the current fiscal year.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk from changes in the interest rates on certain of its outstanding debt. The outstanding loan balance under the $20 million credit facility bears interest at a variable rate based on the bank's prime rate or LIBOR. Based on the average outstanding bank debt for the period ended September 30, 2001, a 100 basis point change in interest rates would not change interest expense by a material amount.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In late January 2001, Rehabilicare was served with documents in connection with a products liability case brought in the California Superior Court for Solano County. Until receipt of these documents, Rehabilicare had no record of the proceedings. The case involved a product liability claim for burns allegedly suffered by plaintiff through the use of a stimulation unit that was allegedly manufactured by Rehabilicare. The action alleged damages for medical expenses of approximately $1,000, for future medical expenses of approximately $270,000 and for punitive damages and pain and suffering of approximately $2.0 million. The action apparently progressed to the entry of a default judgment on January 11, 2001 against Rehabilicare for failing to respond to pleadings.

In March 2001, Rehabilicare moved in Solano County court to set aside the default judgment on various grounds, including irregularities in the filings and other matters. Because the appeal period with respect to the default judgment would have lapsed prior to the hearing on its motion in Solano County, Rehabilicare also appealed the judgment to the California Court of Appeals. The Solano County Court refused to act on Rehabilicare's motion because of the pendency of the appeal. Rehabilicare believes the judgment is void or otherwise improper, has obtained a stay of execution of the judgment in both California and Minnesota and intends to vigorously pursue available actions, including its appeal, to set aside the judgment.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS - None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES - None

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS - None

ITEM 5. OTHER INFORMATION - None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None

(b) Reports on Form 8-K

None filed during the quarter ended September 30, 2001

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

REHABILICARE INC.

November 14, 2001	/s/ David B. Kaysen
Date	David B. Kaysen President and Chief Executive Officer
November 14, 2001	/s/ W. Glen Winchell
Date	W. Glen Winchell Vice President of Finance (Principal Financial and Accounting Officer)