DERMA SCIENCES, INC.
Form 10-Q
May 15, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2009

[ ] 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 small business issuer as specified in its charter)

Pennsylvania	23-2328753
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

214 Carnegie Center, Suite 300
Princeton, New Jersey 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. þ Yes o 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 o 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. 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 smaller reporting company)	Smaller reporting company	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

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

Date: May 15, 2009

Class: Common Stock, par value $.01 per share
Shares Outstanding: 40,140,743

Part I

DERMA SCIENCES, INC.

FORM 10-Q

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Forward Looking Statements

This document includes certain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on management's current expectations and are subject to uncertainty and changes in circumstances. Actual results may differ materially from these expectations due to changes in political, economic, business, competitive, market and regulatory factors.

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Part I Financial Information

Item 1. FINANCIAL STATEMENTS

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

ASSETS	March 31, 2009 (Unaudited)	December 31, 2008
Current Assets		
Cash and cash equivalents	$ 288,605	$ 391,038
Accounts receivable, net	2,818,283	3,892,523
Inventories	11,728,833	12,423,042
Prepaid expenses and other current assets	477,028	397,117
Total current assets	15,312,749	17,103,720
Cash restricted	2,020,734	2,014,422
Equipment and improvements, net	3,696,866	3,977,853
Goodwill	7,119,726	7,119,726
Other intangible assets, net	4,979,749	5,310,129
Other assets, net	643,765	681,472
Total Assets	$ 33,773,589	$ 36,207,322
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Line of credit borrowings	3,534,113	3,446,605
Current maturities of long-term debt	1,290,523	1,298,207
Accounts payable	2,625,477	3,614,764
Accrued expenses and other current liabilities	1,541,653	2,004,493
Total current liabilities	8,991,766	10,364,069
Long-term debt	3,741,670	4,065,036
Other long-term liabilities	42,038	44,848
Deferred tax liability	315,095	340,871
Total Liabilities	13,090,569	14,814,824
Shareholders' Equity		
Convertible preferred stock, $.01 par value; 11,750,000 shares authorized; issued and outstanding: 2,280,407 shares (liquidation preference of $4,210,231 at March 31, 2009)	22,804	22,804
Common stock, $.01 par value; 150,000,000 authorized; issued and outstanding: 40,140,743	401,407	401,407
Additional paid-in capital	40,268,832	40,027,645
Accumulated other comprehensive income cumulative translation adjustments	411,880	604,465
Accumulated deficit	(20,421,903)	(19,663,823)

Total Shareholders' Equity	20,683,020	21,392,498
Total Liabilities and Shareholders' Equity	$ 33,773,589	$ 36,207,322

See accompanying consolidated notes.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Operations (Unaudited)

	Three months ended March 31, 2009	Three months ended March 31, 2008
Net Sales	$ 10,431,891	$ 11,724,822
Cost of sales	7,078,255	8,582,613
Gross Profit	3,353,636	3,142,209
Operating expenses		
Selling, general and administrative	3,864,127	4,320,417
Research and development	130,346	48,108
Total operating expenses	3,994,473	4,368,525
Operating loss	(640,837)	(1,226,316)
Other expense, net:		
Interest expense	171,470	264,915
Other (income) expense	(1,536)	8,614
Total other expense	169,934	273,529
Loss before benefit for income taxes	(810,771)	(1,499,845)
Benefit for income taxes	(52,691)	(90,057)
Net Loss	$ (758,080)	$ (1,409,788)
Loss per common share basic and diluted	$ (0.02)	$ (0.04)
Shares used in computing loss per common share basic and diluted	40,140,743	34,038,207

See accompanying consolidated notes.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows (Unaudited)

	Three months ended March 31, 2009	Three months ended March 31, 2008
Operating Activities		
Net loss	$ (758,080)	$ (1,409,788)
Adjustments to reconcile net loss to net cash provided (used in) by operating activities:		
Depreciation of equipment and improvements	208,246	230,840
Amortization of intangible assets	330,380	288,647
Amortization of deferred financing costs	36,405	21,709
Recovery of bad debts	(27,576)	(3,000)
Allowance for sales adjustments	227,934	207,702
Provision for inventory obsolescence	56,731	22,629
Deferred rent expense	(10,872)	(11,196)
Compensation charge for employee stock options	229,083	187,344
Compensation charge for restricted stock	12,105	12,105
Gain on sale of equipment	(59,031)	-
Deferred income taxes	(14,616)	(90,057)
Changes in operating assets and liabilities:		
Accounts receivable	873,883	(279,947)
Inventories	524,218	(633,841)
Prepaid expenses and other current assets	(84,353)	470,511
Other assets	(148)	(6,413)
Accounts payable	(964,772)	(996,996)
Accrued expenses and other current liabilities	(430,195)	(1,064,807)
Other long-term liabilities	5,335	9,576
Net cash provided by (used in) operating activities	154,677	(3,044,982)
Investing Activities		
Costs of acquiring businesses	-	(104,426)
Purchase of equipment and improvements	(19,655)	(134,428)
Proceeds from sale of equipment	61,000	-
Net cash provided by (used in) investing activities	41,345	(238,854)
Financing Activities		
Net change in bank line of credit	87,508	3,983,185
Deferred financing costs	-	(262,776)
Long-term debt repayments	(331,050)	(320,160)
Net change in restricted cash	(6,312)	-
Proceeds from issuance of stock, net of costs	-	89,177

Net cash (used in) provided by financing activities	(249,854)	3,489,426
Effect of exchange rate changes on cash	(48,601)	(71,024)
Net (decrease) increase in cash and cash equivalents	(102,433)	134,566
Cash and cash equivalents		
Beginning of period	391,038	577,096
End of period	$ 288,605	$ 711,662
Supplemental disclosures of cash flow information:		
Equipment obtained with capital lease	$ -	$ 96,324
Cash paid during the period for:		
Interest	$ 150,845	$ 253,931

See accompanying consolidated notes.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

1. Organization and Summary of Significant Accounting Policies

Derma Sciences, Inc. and its subsidiaries (the Company) is a full line provider of wound care, wound closure and specialty securement devices and skin care products. The Company markets its products principally through independent distributors servicing the long-term care, home health and acute care markets in the United States, Canada and other select international markets. The Company s U.S. distribution facilities are located in St. Louis, Missouri and Houston, Texas, while the Company s Canadian distribution facility is located in Toronto. The Company has manufacturing facilities in Toronto, Canada and Nantong, China.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America 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 United States of America for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three months ended March 31, 2009, are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. Information included in the condensed balance sheet as of December 31, 2008 has been derived from the consolidated financial statements and footnotes thereto for the year ended December 31, 2008, included in Form 10-K previously filed with the Securities and Exchange Commission. For further information, refer to that Form 10-K.

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 common stock in the weighted average number of common shares outstanding for a period, if dilutive. The effects of the assumed exercise of warrants and stock options are determined using the treasury stock method. Potentially dilutive securities have not been included in the computation of diluted loss per share for the three months ended March 31, 2009 and 2008 as the effect would be anti-dilutive.

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

	Three Months Ended March 31,	
	2009	2008
Excluded dilutive shares:		
Preferred stock	2,280,407	2,280,407
Restricted common stock	175,000	175,000
Stock options	8,675,625	8,065,480
Warrants	8,795,259	8,212,759
Total dilutive shares	19,926,291	18,733,646

Reclassifications Certain reclassifications have been made to prior period reported amounts to conform with the 2009 presentation.

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

2. Inventories

Inventories include the following:

	March 31, 2009	December 31, 2008
Finished goods	$ 7,864,711	$ 9,001,269
Work in process	384,835	443,511
Packaging materials	802,819	700,948
Raw materials	2,676,468	2,277,314
Total inventory	$11,728,833	$12,423,042

3. U.S. Line of Credit

In November, 2007, the Company entered into a new five-year revolving credit agreement providing for maximum borrowings of $8,000,000 with a U.S. lender. Advances under the revolving credit agreement may be drawn, from time to time, up to the amount of 85% of eligible receivables (as defined) and 42% of eligible inventory (as defined). Interest on outstanding advances under the revolving credit agreement is payable at the LIBOR monthly rate (the Base Rate) plus 2.75% (the Base Rate Margin) (3.27% at March 31, 2009). In addition, the Company pays a monthly unused line fee of 0.5% per annum on the difference between the daily average amount of advances outstanding under the agreement and $8,000,000 together with a monthly collateral management fee of $2,000. Outstanding balances under the agreement are secured by all of the Company s and its subsidiaries existing and after-acquired tangible and intangible assets located in the United States and Canada. At March 31, 2009 the Company had an outstanding balance of $3,534,113 under this agreement.

The revolving credit agreement is subject to financial covenants which require maintaining a minimum cumulative EBITDA level and certain ratios of fixed charge coverage, senior debt leverage and total debt leverage as defined in the agreement. Additional covenants governing permitted investments, indebtedness and liens, together with payments of dividends and protection of collateral, are also included in the agreement. The revolving credit agreement contains a subjective acceleration provision whereby the lender can declare a default upon a material adverse change in the Company s business operations.

On March 31, 2009, the Company s U.S. lender agreed to amend the credit and security agreement to allow the Company to enter into a forbearance agreement with Western Medical to postpone payment of its promissory note due April 18, 2009 and to allow subsequent payments on the subordinated debt beginning in April 2010 provided the Company achieves predetermined liquidity and free cash flow (as defined) objectives and provided Western Medical further extends for one year the payment of the principal balance, if any, remaining on the promissory note after giving effect to the April, 2010 payment. In return for the amendment, the Company agreed to change its base rate for interest charged to a three month LIBOR rate from a one month LIBOR rate. Further, effective April 1, 2009 the base rate margin was increased 150 basis points on the revolving line of credit from 2.75% to 4.25%, on the term loan from 4.25% to 5.75% and on the portion of the term loan secured by restricted cash from 2.25% to 3.75%. In addition, the Company is obligated to increase the revolving loan availability on its revolving line of credit to a minimum of $3,000,000 by December 31, 2009. Failure to achieve the minimum revolving loan availability amount will result in the base rate changing to the greater of 3.00% or the actual rate in effect.

Effective August 13, 2008, the Company s lender agreed to waive all prior financial and reporting covenant defaults and amend the existing minimum EBITDA, fixed charge coverage, senior debt leverage and total debt leverage covenants to allow the Company to continue to implement its growth strategy in line with the lender s minimum liquidity terms. Amendment of the covenants was predicated upon the Company segregating $2,000,000 in a restricted account the use of which is subject to the approval of the lender. The Company s maximum revolver

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

borrowing capacity remained unchanged. The Company incurred fees of $25,000 associated with the granting of the covenant amendment.

Effective March 28, 2008, the Company s U.S. lender agreed to waive all prior financial and reporting covenant defaults and amend the existing minimum EBITDA, fixed charge coverage, senior debt leverage and total debt leverage covenants, to be measured on a quarterly basis, to allow the Company to implement its growth strategy. Amendment of the covenants was predicated upon the Company s commitment to raise a minimum of $3,000,000 by May 1, 2008 from the sale of equity and agreement to limit its maximum revolver borrowing to the lesser of (a) the revolver loan commitment ($8,000,000) or (b) the borrowing base (as defined), less $1,500,000. Not less than $3,000,000 of the equity infusion was required to be applied to the then existing revolver balance which amount will be credited as a component of EBITDA for covenant compliance purposes. The Company incurred fees of $250,000 associated with the granting of the covenant amendment, together with related expenses of $10,829 which are included as additions to deferred financing costs. In March, 2008 the equity infusion requirement was met (see Note 5).

4. Long-Term Debt

U.S. Term Loan

In November, 2007, the Company entered into a five-year $6,000,000 term loan agreement with a U.S. lender. Interest on the term loan is payable at the LIBOR monthly rate plus 4.25%, (4.77% at March 31, 2009). Monthly payments of principal in the amount of $100,000 together with interest are due under the agreement. The agreement is secured by all of the Company s and its subsidiaries existing and after-acquired tangible and intangible assets located in the United States and Canada.

The term loan agreement is subject to financial covenants which require maintaining a minimum cumulative EBITDA level and certain ratios of fixed charge coverage, senior debt leverage and total debt leverage as defined in the agreement. Additional covenants governing permitted investments, indebtedness and liens, together with payments of dividends and protection of collateral, are also included in the agreement. The term loan agreement contains a subjective acceleration provision whereby the lender can declare a default upon a material adverse change in the Company s business operations.

Effective August 13, 2008 and March 28, 2008, the foregoing financial covenants were amended as described in the third and fourth paragraphs under the heading Line of Credit Borrowings (see Note 3).

Long-term debt includes the following:

	March 31, 2009	December 31, 2008
U.S. term loan	$4,400,000	$4,700,000
Promissory note	500,000	500,000
Capital lease obligations	132,193	163,243
Total debt	5,032,193	5,363,243
Less: current maturities	1,290,523	1,298,207
Long-term debt	$3,741,670	$4,065,036

Promissory Note

In connection with the acquisition of Western Medical in April 2006, a portion of the purchase price was paid via a three-year unsecured promissory note issued to the seller. The promissory note originally provided for the

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

payment of simple interest of 12% in 11 quarterly installments of $15,000 and a final payment of accrued interest of $15,000 and the principal balance of $500,000 on April 18, 2009.

On March 31, 2009, the Company entered into a Forbearance Agreement (the Agreement) with Western Medical to postpone payment of its $500,000 promissory note due April 18, 2009. The Company will continue to make interest payments when due and a final payment of the principal plus accrued interest through the date of payment on April 14, 2010. In consideration for the postponement, the Company agreed to grant Western Medical warrants to purchase 50,000 shares of the Company s common stock at the market price on the date of execution of the Agreement. The value of the warrants are being recognized as interest expense over the postponement period.

Capital Lease Obligations

The Company has two capital lease obligations for certain office furniture and distribution equipment totaling $132,193 as of March 31, 2009. The capital lease obligations bear interest at annual rates ranging from 6.8% to 9.6% with the longest lease term expiring in February 2011.

5. Shareholders Equity

Preferred Stock

There are 150,003 shares of series A convertible preferred stock outstanding at March 31, 2009. The series A preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $4.00 per share, votes as a class on matters affecting the series A preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 440,003 shares of series B convertible preferred stock outstanding at March 31, 2009. The series B preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference of $6.00 per share, votes as a class on matters affecting the series B preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 619,055 shares of series C convertible preferred stock outstanding at March 31, 2009. The series C preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.70 per share, votes as a class on matters affecting the series C preferred stock and maintains voting rights identical to the common stock on all other matters.

There are 1,071,346 shares of series D convertible preferred stock outstanding at March 31, 2009. The series D preferred stock is convertible into common stock on a one-for-one basis, bears no dividend, maintains a liquidation preference averaging $0.50 per share, votes as a class on matters affecting the series D preferred stock and maintains voting rights identical to the common stock on all other matters.

Common Stock

In March 2008, the Company raised $5,610,871 (net of $489,129 in commission and other offering expenses) from the private sale of 6,100,000 shares of common stock at a price of $1.00 per share, together with 3,050,000 five-year warrants to purchase one share of common stock at a price of $1.20 per share. In addition, the placement agent for the shares sold received 142,500 five-year warrants to purchase one share of common stock at $1.20 per share. The proceeds were used to meet the minimum equity infusion requirements associated with the Company s March 28, 2008 amended bank covenants, support the Company s strategic growth initiatives and increase working capital.

In January 2008, the Company issued 210,988 shares of common stock as follows: (a) 100,000 shares in consideration of $105,000 upon exercise of series G warrants, (b) 19,800 shares in consideration of $12,375 upon exercise of 19,800 stock options, and (c) 91,188 shares upon cashless exercise of 178,200 stock options.

DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

Stock Purchase Warrants

At March 31, 2009, the Company had warrants outstanding to purchase 8,795,259 shares of the Company s common stock as outlined below:

Series	Number of Warrants	Exercise Price	Expiration Date
H	2,655,098	$1.00	April 30,2011
I	754,806	$0.72	April 30, 2011
J	2,142,855	$0.77	May 31, 2013
K	3,192,500	$1.20	April 1, 2013
L	50,000	$0.39	March 31, 2014
Total	8,795,259		

Stock Options

The Company has a stock option plan under which options to purchase a maximum of 10,000,000 shares of common stock may be issued. The plan permits the granting of both incentive stock options and nonqualified stock options to employees and directors of the Company and certain outside consultants and advisors to the Company. The option exercise price may not be less than the fair market value of the stock on the date of the grant of the option. The duration of each option may not exceed 10 years from the date of grant. Under the plan, options to purchase 900,000 and 50,000 shares of common stock were granted to officers, directors, agents and employees for the three months ended March 31, 2009 and 2008, respectively, with exercise prices ranging from $0.39 to $1.11 per share. For the three months ended March 31, 2009 and 2008, 10,000 plan options were forfeited and for the three months ended March 31, 2008, 198,000 plan options were exercised. As of March 31, 2009, options to purchase 7,019,625 shares of the Company s common stock were issued and outstanding under the plan.

The Company has previously granted nonqualified stock options to officers, directors, agents and employees outside of the stock option plan (non-plan options). All non-plan options were granted at the fair market value at the date of grant. During the three months ended March 31, 2009, 237,000 non-plan options expired. As of March 31, 2009, non-plan options to purchase 1,656,000 shares of the Company s common stock were issued and outstanding.

For the three months ended March 31, 2009 and 2008 the fair value of each service and performance based option award was estimated at the date of grant using the Black-Scholes option pricing model. The weighted-average assumptions for the three months ended March 31, 2009 and 2008 were as follows:

	2009	2008
Risk-free interest rate	2.27%	2.14%
Volatility factor	94.3%	162%
Dividend yield	0%	0%
Expected option life (years)	6.25	6.25
Contractual life (years)	10	10

In both 2009 and 2008, the risk-free rate utilized represents the U.S. Treasury yield curve rate which approximates the risk-free rate for the expected option life at the time of grant. In 2009 and 2008, the volatility factor was calculated based on the seventy-five month-end closing prices of the Company s common stock preceding the month of stock option grant. The Company uses a seventy-five month volatility period to coincide with the expected stock option life. Based on guidance from Staff Accounting Bulletin 107 and 110, a stock option life of 6.25 years was utilized under the simplified method. The dividend yield is 0% since the Company does not anticipate paying dividends in the near future. Based on the Company s historical experience of options that expire or are cancelled before becoming fully vested, the Company assumed an annualized forfeiture rate of 1.0% for all

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DERMA SCIENCES, INC. AND SUBSIDIARIES

Notes To Condensed Consolidated Financial Statements (Unaudited)

options. Under the true-up provision of SFAS 123R, the Company will record additional expense if the actual forfeiture rate is lower than estimated, and will record a recovery of