REHABILICARE INC
Form 10-Q
May 14, 2001

1

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 March 31, 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 May 11, 2001 was:

COMMON STOCK, $.10 PAR VALUE	10,732,652 SHARES

2

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 collection rates, it might be required to charge off a portion of uncollected receivables, significantly impacting earnings.

- The Company has incurred a significant amount of indebtedness to finance acquired businesses. The interest expense on such indebtedness reduces earnings and could cause the Company to be short of cash if its operations do not meet expectations.

- In the United States, the Company's products and services are frequently reimbursed by private and public insurers 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 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, the Company 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 revenue and earnings.

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

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Included herein is the following unaudited condensed financial information:

Consolidated Balance Sheets as of March 31, 2001 and June 30, 2000

Consolidated Statements of Operations for the three months and nine months ended March 31, 2001 and 2000

Consolidated Statements of Cash Flows for the nine months ended March 31, 2001 and 2000

Notes to Consolidated Financial Statements

REHABILICARE INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	March 31, 2001
ASSETS	
CURRENT ASSETS:	
Cash and cash equivalents	$ 1,620,445
Receivables, less reserve for uncollectible accounts of $7,867,778 and $6,575,715	17,595,332
Inventories -	
Raw materials	2,044,942
Work in process	12,445
Finished goods	6,101,853
Deferred tax assets	3,351,294
Prepaid expenses	2,006,531
Total current assets	32,732,842
PROPERTY, PLANT AND EQUIPMENT:	13,398,412
Less accumulated depreciation	(8,220,200
Net property, plant and equipment	5,178,212
Intangible assets, net	11,527,462
Deferred tax assets	194,771
Other assets	170,953
	$ 49,804,240
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Current maturities of long-term debt	$ 2,162,276
Note payable	1,100,000
Accounts payable	2,819,364
Medicare lawsuit payable	--

Accrued liabilities -	
Payroll	326,956
Commissions	296,387
Income taxes	691,674
Other	2,142,543
Total current liabilities	9,539,200
LONG-TERM LIABILITIES:	
Long term-debt	11,323,442
Deferred tax liabilities	732,894
Total liabilities	21,595,536
STOCKHOLDERS' EQUITY	
Common stock, $.10 par value: 25,000,000 shares authorized; issued and outstanding 10,732,652 and 10,558,710 shares, respectively	1,073,265
Preferred stock, no par value; 5,000,000 shares authorized; none issued and outstanding	--
Additional paid-in capital	21,279,693
Less note receivable from officer/stockholder	(189,417
Accumulated other non-owner changes in equity	(466,156
Retained earnings	6,511,319
Total stockholders' equity	28,208,704
	$ 49,804,240

4

5

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

	Three Months Ended March 31		
	2001	2000	
Net sales and rental revenue	$ 15,171,676	$ 13,949,721	$ 45,2

Cost of sales and rentals	4,822,818	4,141,278	14,2
Gross profit	10,348,858	9,808,443	31,0
Operating expenses:			
Selling, general and administrative	8,048,582	7,888,129	23,8
Research and development	493,643	340,244	1,3
Total operating expenses	8,542,225	8,228,373	25,1
Income from operations	1,806,633	1,580,070	5,9
Other income (expense):			
Interest expense	(313,035)	(410,628)	(1,0
Gain on sale of building	--	--	
Minority interest	--	(3,850)	
Other income (expense)	14,376	(10,176)	
Income before income taxes	1,507,974	1,155,416	4,9
Provision for income taxes	646,000	486,000	2,1
Net income	$ 861,974	$ 669,416	$ 2,8
Net income per common and common equivalent share			
Basic	$ 0.08	$ 0.06	$
Diluted	$ 0.08	$ 0.06	$
Weighted average number of shares outstanding			
Basic	10,788,277	10,569,275	10,7
Diluted	10,844,363	10,612,967	10,7

5

6

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

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	2001
OPERATING ACTIVITIES:	
Net income	$ 2,806,237
Adjustments to reconcile net income to net cash provided by (used in) operating activities	
Gain on sale of building	--
Depreciation and amortization	1,708,614
Change in long-term portion of deferred taxes	178,119
Minority interest	--
Change in current assets and liabilities, excluding effects of business combinations	
Receivables	1,672,919
Inventories	277,415
Prepaid expenses	(647,969)
Accounts payable	(1,966,171)
Accrued liabilities	(1,578,100)
Net cash provided by (used in) operating activities	2,451,064
INVESTING ACTIVITIES:	
Purchases of property and equipment	(265,361)
Cash paid in asset acquisition, net of cash received	--
Proceeds from sale of building	--
Change in other assets, net	(477,956)
Net cash used in investing activities	(743,317)
FINANCING ACTIVITIES:	
Proceeds from new financing	--
Principal payments on long-term obligations	(2,326,566)
Proceeds from (payments on) line of credit, net	(100,000)
Payment of capital lease obligation	--
Proceeds from exercise of stock options	314,375
Proceeds from employee stock purchase plan	108,975
Net cash provided by (used in) financing activities	(2,003,216)
Effect of exchange rates on cash and cash equivalents	(311,438)
Net increase (decrease) in cash and cash equivalents	(606,907)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	2,227,352
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 1,620,445
SUPPLEMENTAL CASH FLOW INFORMATION	
Interest paid	$ 1,025,743
Income taxes paid	$ 2,582,920

REHABILICARE INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2001

1. ACCOUNTING POLICIES

The amounts set forth in the preceding financial statements are unaudited as of and for the periods ended March 1, 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 significant accounting policies and certain financial information which are normally included in financial statements prepared in accordance with generally accepted accounting principles, but which are not required for interim reporting purposes, have been omitted. The accompanying financial statements of the Company should be read in conjunction with the audited consolidated financial statements for the year ended June 30, 2000 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. BUSINESS COMBINATIONS

On July 16, 1999, the Company acquired substantially all the assets of Compex SA, a Swiss-based medical products company for cash of approximately $11.0 million. The acquisition was financed principally with debt and provided for additional contingent consideration of up to $2 million based on the performance of Compex through December 31, 2000. In connection with the acquisition, the purchase consideration and transaction costs were allocated as follows:

Net assets acquired	$ 1,612,085
Goodwill	9,060,772
Developed technology	1,400,000
Existing workforce	1,400,000
Debt structuring costs	346,970
	$13,819,827

Included in goodwill are contingent payments of $1,777,185 and $222,815 made during fiscal 2000 and 2001, respectively, to the former Compex shareholders.

3. NOTE PAYABLE AND LONG TERM DEBT

In conjunction with its acquisition of Compex SA, the Company entered into a new $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. The initial term loan of $15,000,000 was used to fund the acquisition and repay the balance of a note and a revolving loan provided under a credit facility with another bank.

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. There remained $11,247,000 outstanding under the term loan, bearing interest at 7.44%, at March 31, 2001. There were borrowings of $1,100,000 under the revolving line of credit as of March 31, 2001, with a weighted average interest rate of 8.0%.

The Company was in compliance with all financial covenants in its credit agreement as of March 31, 2001 and for the period then ended.

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 Nine Months Ended March 31	
	2001	
United States revenue	$ 33,184,315	$
Foreign revenue	12,083,725	
	$ 45,268,040	$

Net revenue by product line was as follows:

	For the Nine Months Ended March 31	
	2001	2
Rehabilitation products	$ 9,194,245	$ 8
Pain management	10,571,689	10
Consumer Products	8,592,509	8
Accessories and supplies	6,909,597	15

	$ 45,268,040	$ 42
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During the first nine months of fiscal 2001, one customer accounted for approximately 13% of total consolidated revenue. This customer represented approximately 6% of total accounts receivable at March 31, 2001.

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 March 31	Nine Mo Ma

	2001	2000	2001
Net sales and rental revenue	100.0%	100.0%	100.0%
Cost of sales and rentals	(31.8)	(29.7)	(31.4)
Gross profit	68.2	70.3	68.6
Operating expenses -			
Selling, general and administrative	(53.0)	(56.6)	(52.6)
Research and development	(3.3)	(2.4)	(2.9)
Total operating expenses	(56.3)	(59.0)	(55.5)
Income from operations	11.9	11.3	13.1
Other income (expense), net	(1.9)	(3.0)	(2.2)
Gain on sale of building	--	--	--
Income tax provision	(4.3)	(3.5)	(4.7)
Net income	5.7	4.8	6.2

Revenue was $15,172,000 for the third quarter of fiscal 2001, a 9% increase from $13,950,000 for the third quarter of fiscal 2000. Revenue for the nine months ended March 31, 2001 increased 6% to $45,268,000 from $42,604,000 for the nine months ended March 31, 2000. The increase was primarily attributable to United States operations where revenue increased 15% in the third quarter and 7% for the first nine months of fiscal 2001 over the same period in fiscal 2000. The Company continues its recovery from the impact of a whistleblower lawsuit disclosed in the third quarter of fiscal 2000, which adversely impacted earnings growth during the last half of fiscal 2000. Compex accounted for $3,393,000 of revenue in the third quarter and $11,248,000 for the nine months ended March 31, 2001, compared to $3,624,000 in the third quarter and $10,643,000 for the nine months ended March 31, 2000. Revenue from Compex was lower than expected in the third quarter of fiscal 2001 due to the effects of a strengthening U.S. dollar against European currencies and to slower than anticipated orders from a major customer.

Gross profit was $10,349,000 or 68.2% of revenue for the third quarter and $31,049,000 or 68.6% of revenue for the nine months ended March 31, 2001 compared with $9,808,000 or 70.3% of revenue for the third quarter and $29,757,000 or 69.8% of revenue for the nine months ended March 31, 2000. Cost of sales in the first quarter of fiscal 2000 included a one-time charge of $645,000 related to the step-up in basis of inventory recorded in connection with the Compex acquisition. Without that charge, gross profit would have been 71.3% of revenue for the nine months. The current year reduction in gross profit resulted primarily from increased focus on sales of Compex sport products at wholesale prices to retail store outlets, rather than direct to consumers at retail prices. The change in strategy is expected to expand market penetration.

Selling, general and administrative expenses increased 2% to $8,048,000 in the third quarter of fiscal 2001 from $7,888,000 in fiscal 2000. As a percent of revenue, those expenses decreased from 57% to 53%. For the nine months ended March 31, 2001, those expenses increased 4% to $23,813,000 from $22,888,000 in fiscal 2000, but stayed the same as a percentage of revenue at approximately 53%. The 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 expense increased 45% to $494,000 in the third quarter of fiscal 2001, compared with $340,000 in fiscal 2000. For the nine months ended March 31, 2001, these costs increased 41% to $1,334,000 compared to $947,000 in fiscal 2000. Those increases reflect expanded new product development activities both in the U.S. where two new products are scheduled for introduction later in calendar 2001 and in Europe where one new sport product was introduced in April 2001.

Interest expense decreased slightly from $1,165,000 in the nine months ended March 31, 2000 to $1,026,000 in the current period. The decrease resulted from slightly lower interest rates and lower outstanding borrowings under the Company's credit facility.

Operating results for the nine months ended March 31, 2000 include a gain on the sale of the former Staodyn building in Longmont, Colorado in the amount of $1,076,000. The Company exercised its option to purchase that building in the first quarter of fiscal 1999 and closed the purchase and the subsequent sale on July 7, 1999.

The provision for income taxes was increased from 40% of income before taxes in the first quarter of fiscal 2001 to 43% for the nine months ended March 31, 2001, compared with 42% in both periods in the prior year. 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. In addition, the Company has relocated certain operations and negotiated new agreements with certain European taxing authorities. The Company believes that 43% is a reasonable estimate of the effective rate for fiscal 2001 based on most recent estimates of expected sources of revenue and expenses for the entire year.

As a result of all the above activity, net income increased from $669,000 in the third quarter of fiscal 2000 to $862,000 in the third quarter of fiscal 2001. For the nine months ended March 31, 2001 net income decreased to $2,806,000 from $3,336,000 during the same period in fiscal 2000. Diluted earnings per share increased from $.06 to $.08 for the third quarter and decreased from $.31 to $.26 for the nine month period. Before the one time gain related to the building sale and the one time charge related to the Compex inventory step-up, net income was $3,085,000 of $.29 per share for the nine months ended March 31, 2000.

LIQUIDITY AND CAPITAL RESOURCES

During the nine months ended March 31, 2001, the Company's operations provided cash of $2,451,000, mainly from net income and a reduction in inventory and accounts receivable of $277,000 and $1,673,000, respectively. These amounts were offset by an increase in prepaid expenses of $648,000 and decreases of $1,966,000 in accounts payable and $1,578,000 in accrued liabilities. The decrease in account payable was due mainly to the payment of $1,677,000 for the settlement for the Medicare whistleblower suit.

The Company used $743,000 in investing activities in the nine months ended March 31, 2001 for net purchases of property and equipment and a net increase in clinical and rental equipment.

The Company's financing activities used $2,003,000 of cash during the nine months ended March 31, 2001, mainly for the repayment of borrowings under the $20,000,000 credit facility used to finance the Compex acquisition. The Company initially borrowed $15,000,000 under the credit facility to finance the Compex purchase and to repay an outstanding note. At March 31, 2001, $11,247,000 is outstanding under the facility.

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 uncollectible 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 March 31, 2001 is adequate to cover future losses on its receivables based on collection history and trends. The provision for uncollectible accounts recorded in the income statement may continue to fluctuate significantly from quarter to quarter as such trends change. The reserve was 30.9% of receivables at March 31, 2001 compared to 25.4% at June 30, 2000. The Company believes that the ratio will be favorably impacted in the future as a result of including receivables from Compex SA and Rehabilicare (UK) Ltd. which are more traditional trade receivables and not dependent on third party payors.

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 March 31, 2001, a 100 basis point change in interest rates would not change interest expense by a material amount.

12

13

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, however, 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 March 31, 2001

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.

May 15, 2001	/s/ David B. Kaysen
Date	David B. Kaysen President and Chief Executive Officer
May 15, 2001	/s/ W. Glen Winchell
Date	W. Glen Winchell Vice President of Finance (Principal Financial and Accounting Officer)