REHABILICARE INC
Form 10-Q
February 14, 2002

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 December 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 February 8, 2002 was:

COMMON STOCK, $.10 PAR VALUE 10,913,458 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 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's operating results.

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Included herein is the following unaudited condensed financial information:

Consolidated Balance Sheets as of December 31, 2001 and June 30, 2001

Consolidated Statements of Operations for the three months and six months ended December 31, 2001 and 2000

Consolidated Statements of Cash Flows for the six months ended December 31, 2001 and 2000

Notes to Consolidated Financial Statements

REHABILICARE INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

ASSETS

Current Assets:
Cash and cash equivalents
Receivables, less reserve for uncollectible accounts of $8,951,393 and $8,062,378
Inventories -
Raw materials
Work in process
Finished goods
Deferred tax assets
Prepaid expenses

Total current assets

Property, plant and equipment, net
Intangible assets, net
Deferred tax assets
Other assets

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities:
Note payable
Current maturities of long-term debt
Accounts payable
Accrued liabilities -
Payroll
Commissions
Income taxes
Other

Total current liabilities

Long-Term Liabilities:
Long term-debt
Deferred tax liabilities

Total liabilities

Stockholders' Equity:

Common stock, $.10 par value: 25,000,000 shares authorized; issued and outstanding 10,844,090 and 10,792,060 shares, respectively
Preferred stock, no par value; 5,000,000 shares authorized; none issued and outstanding

Additional paid-in capital
Less note receivable from officer/stockholder
Unearned compensation on restricted stock
Accumulated other non-owner changes in equity
Retained earnings

Total stockholders' equity

REHABILICARE INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended December 31	
	2001	2000
Net sales and rental revenue	$ 17,533,144	$ 15,028,717
Cost of sales and rentals	6,029,483	4,646,357
Gross profit	11,503,661	10,382,360
Operating expenses:		
Selling, general and administrative	8,468,506	8,047,110
Research and development	459,957	481,563
Total operating expenses	8,928,463	8,528,673
Income from operations	2,575,198	1,853,687
Other income (expense):		
Interest expense	(180,049)	(333,821)
Other	5,815	16,219
Income before income taxes	2,400,964	1,536,085
Income tax provision	1,009,000	714,000

Net income	$ 1,391,964	$ 822,085
	============	============
Net income per common and common equivalent share		
Basic	$ 0.13	$ 0.08
	============	============
Diluted	$ 0.12	$ 0.08
	============	============
Weighted average number of shares outstanding		
Basic	10,825,500	10,764,487
	============	============
Diluted	11,183,703	10,778,078
	============	============

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REHABILICARE INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

Operating Activities:

Net income
Adjustments to reconcile net income to net cash provided by operating activities
Depreciation and amortization
Amortization of unearned compensation
Change in long-term portion of deferred taxes
Changes in current assets and liabilities
Receivables
Inventories
Prepaid expenses
Accounts payable
Accrued liabilities

Net cash provided by operating activities

Investing Activities:
Purchases of property and equipment
Change in other assets, net

Net cash used in investing activities

Financing Activities:
Principal payments on long-term obligations
Proceeds from (payments on) line of credit, net
Proceeds from exercise of stock options
Proceeds from employee stock purchase plan

Net cash provided by (used in) financing activities

Effect of exchange rates on cash and cash equivalents

Net increase (decrease) in cash and cash equivalents

Cash and Cash Equivalents at Beginning of Period

Cash and Cash Equivalents at End of Period

Supplemental Cash Flow Information

Interest paid

Income taxes paid

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

1. Accounting Policies

The amounts set forth in the preceding financial statements are unaudited as of and for the periods ended December 31, 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 stockholders' equity.

2. Recently Issued Accounting Standards

In June 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets, effective for fiscal years beginning after December 15, 2001, with early adoption permitted for companies with fiscal years beginning after March 15, 2001. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the statements. Other intangible assets will continue to be amortized over their useful lives.

The Company adopted the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of fiscal 2002. Amounts previously recorded as separately identifiable intangibles for acquired work force and customer list have been subsumed to goodwill in accordance with FAS 141, increasing goodwill by $1.6 million as of the date of adoption. Effective with the July 1, 2002 adoption of FAS 142, goodwill is no longer amortized but is instead subject to an annual impairment test. The transitional impairment test conducted in connection with the adoption of FAS 142 resulted in no impairment being required.

Goodwill and other intangible assets resulting from acquisitions of business and the formation of the Company consist of the following:

	As of June 30, 2001	As of December 31, 2001
Goodwill	$11,504,520	$11,504,520
Less accumulated amortization	1,671,430	1,671,430
Net goodwill	9,833,090	9,833,090
Other intangible assets:	1,783,686	1,783,686
Less accumulated amortization	366,015	499,524
Net other intangible assets	1,417,671	1,284,162
Total intangible assets, net	$11,250,761	$11,117,252

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With the adoption of FAS 142, the Company ceased amortization of goodwill as of July 1, 2001. The following table presents the results of the Company for all periods presented on a comparable basis:

	Six Months Ended December 31, 2001	Six Months Ended December 31, 2000
Reported net income attributed to common shareholders	$ 2,582,987	$ 1,944,263
Add back goodwill amortization, net of tax provision	--	237,512
Adjusted net income attributed to common shareholders	$ 2,582,987	$ 2,181,775

Diluted net income per share:		
Reported net income attributed to common shareholders	$ .23	$ .18
Goodwill amortization	--	.02
Adjusted net income attributed to common shareholders	.23	.20

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 December 31, 2001, there were borrowings outstanding of $9,097,000 under the long-term note and $2,000,000 under the revolving credit line.

Borrowings under the credit facility are secured by substantially all of the U.S. assets of the Company other than those pledged as collateral on existing lease or mortgage obligations. The interest rate on the term loan was 4.56% at December 31, 2001 and the weighted average rate on borrowings under the revolving line of credit was 5.88%.

The Company was in compliance with all financial covenants of its credit agreement as of December 31, 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, rehabilitation and sports training 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 Six Months Ended December 31	
	2001	2000
U.S. revenue	$22,480,856	$21,692,082
Foreign revenue	11,151,016	8,404,282
	$33,631,872	$30,096,364

Net revenue by product line was as follows:

	For the Six Months Ended December 31	
	2001	2000
Rehabilitation products	$ 6,998,031	$ 6,139,659
Pain management	6,918,857	6,990,371
Consumer Products	8,168,861	5,997,539
Accessories and supplies	11,546,123	10,968,795
	$33,631,872	$30,096,364

During the first six months of fiscal 2002 and 2001, one customer accounted for approximately 16% and 15%, respectively, of total consolidated revenue. This customer represented approximately 5% of total accounts receivable at December 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 and the United Kingdom, through direct rental or sale to patients.

The direct rental or sale approach in the United States 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 December 31	
	2001	2000
Net sales and rental revenue	100.0%	100.0%
Cost of sales and rentals	(34.4)	(30.9)
Gross profit	65.6	69.1
Operating expenses -		
Selling, general and administrative	(48.3)	(53.6)
Research and development	(2.6)	(3.2)
Total operating expenses	(50.9)	(56.8)
Income from operations	14.7	12.3
Other income (expense), net	(1.0)	(2.0)
Income tax provision	(5.8)	(4.8)
Net income	7.9	5.5

Revenue was $17,533,000 for the second quarter of fiscal 2002, a 17% increase from $15,029,000 for the second quarter of fiscal 2001. Revenue for the six months ended December 31, 2001 increased 12% to $33,632,000 from $30,096,000 in the first six months of fiscal 2001. The largest component of those increases was the Company's Compex operation where revenue increased 54% in the second quarter and 35% in the first six months of fiscal 2002 over the same periods in fiscal 2001. Compex's revenue increases resulted from volume increases in all markets, particularly Spain. Revenue from U.S. operations was up 4% in the second quarter and first six months of fiscal 2002 compared to the same period in fiscal 2001. Increases in revenue from direct rental or sale to patients of 11% in the second quarter and 9% in the first six months resulted primarily from increased sales of units and supplies. Those increases were offset by declines in sales to medical product dealers and distributors as many of them converted some of their purchases to lower priced, often imported, units.

Gross profit was $11,504,000 or 65.6% of revenue in the second quarter and $22,455,000 or 66.8% of revenue for the first six months of fiscal 2002, compared with $10,382,000 or 69.1% of revenue in the second quarter and $20,700,000 or 68.8% of revenue for the first six months of fiscal 2001. The decline in the gross margin percentage resulted from continued growth of Compex revenue as a percent of total revenue and further reductions in the Compex gross margin percentage as a result of changes in product mix toward lower price sport and fitness products. Overall margins are expected to continue in the mid-sixties.

Selling, general and administrative expenses increased 5% to $8,469,000 in the second quarter of fiscal 2002 from $8,047,000 in fiscal 2001. As a percent of revenue, those expenses declined to 48% in the second quarter of fiscal 2002 from 54% in fiscal 2001. For the six months ended December 31, 2001, selling, general and administrative expenses increased 5% to $16,493,000 from $15,764,000 in fiscal 2001. As a percent of revenue, those expenses declined to 49% during the first six months of fiscal 2002 from 52% in fiscal 2001. The declines result from Compex expenses increasing at a rate slower than the related increase in its revenue as newer markets achieve significant growth. In the U.S., those expenses are essentially unchanged as a percent of revenue after adjusting for the effect of discontinuing amortization of goodwill as described in Note 2 to the financial statements.

Research and development expense decreased 5% to $460,000 in the second quarter of fiscal 2002. In the six months ended December 31, 2001, those costs increased 31% to $1,102,000 compared to $840,000 in fiscal 2001. The increase in the six-month period reflects the cost of new product development activities both in the U.S. and Compex operations. The most significant project in the U.S. was the new ProMax TENS unit which started production in October 2001. In Europe, three new products have been introduced in the last nine months. The Company anticipates that research and development expenses will remain relatively constant as a percentage of revenue in future periods.

Interest expense decreased 46% from $334,000 in the first quarter of fiscal 2001 to $180,000 in the first quarter of fiscal 2002 and decreased 42% from $713,000 in the first six months of fiscal 2001 to $415,000 in fiscal 2002. The decreases 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.

The provision for income taxes is 42% of income before taxes for the first six months of fiscal 2002 compared to 43% for the same period of fiscal 2001. The Company 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 and 1998. The Internal Revenue Service has recently completed an examination of the Company's federal income taxes for the years ended June 30, 1997 and has proposed adjustments pursuant to such audit, most of which relate to the timing of revenue or expense recognition. The Company is contesting certain proposed adjustments and believes its provision for income taxes and related reserves are adequate.

As a result of the above activity, net income increased from $822,000 in the second quarter of fiscal 2001 to $1,392,000 in the second quarter of fiscal 2002. For the six months ended December 31, 2001, net income increased to $2,583,000 from $1,944,000 during the same period in fiscal 2001. Diluted earnings per share increased from $.08 to $.12 for the second quarter and $.18 to $.23 per share for the six month period.

LIQUIDITY AND CAPITAL RESOURCES

For the six months ended December 31, 2001, the Company's operations provided cash of $1,712,000, mainly from net income of $2,583,000 less the net increase in current assets. Prepaid expenses declined due to lower value added tax prepayments by Compex. Inventories increased $609,000, primarily for the

build-up of raw materials and finished goods for new product lines at Compex. Accounts receivable increased $1,094,000, mainly from higher sales at Compex. The decrease in accounts payable relates to timing differences and the payment of year-end accruals.

The Company used $426,000 in investing activities for the first six months of fiscal 2002 for net purchases of property and equipment, including clinical and rental equipment.

The Company's financing activities provided $254,000 of cash during the first six months of fiscal 2002, mainly from borrowings under its $20,000,000 credit facility, net of $1,871,000 that was used for repayment of long-term debt under that facility. Borrowings were used primarily to build inventories in connection with new product introductions. At December 31, 2001, a total of $11,097,000 is outstanding under this facility, including $2,000,000 of short-term debt under 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 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 December 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 30.5% of receivables at December 31, 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.

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PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In late January 2001, Rehabilicare was served with documents in connection with a product 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 $2,000,000. The action 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 December 31, 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.

February 14, 2002	/s/ David B. Kaysen
Date	David B. Kaysen President and Chief Executive Officer
February 14, 2002	/s/ W. Glen Winchell
Date	W. Glen Winchell Vice President of Finance (Principal Financial and Accounting Officer)