MFIC CORP
Form 10-Q
November 12, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2003

Or

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

For the transition period from To

Commission file number 0-11625

MFIC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**04-2793022**
(State or Other Jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)

30 Ossipee Road, P.O. Box 9101, Newton, Massachusetts 02464

(Address of principal Executive Offices) (Zip Code)

617-969-5452

(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 ý No o

Registrant had 7,516,962 shares of common stock, par value $.01 per share, outstanding on November 10, 2003.

MFIC CORPORATION

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MFIC CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2003 (unaudited)	December 31, 2002
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 104,080	$ 84,956
Accounts receivable (less allowance for doubtful accounts of $54,611 and $45,233 at September 30, 2003 and at December 31, 2002, respectively)	1,410,685	2,458,108
Inventories	4,156,104	3,898,098
Prepaid expenses	150,600	192,518
Other current assets	132,191	166,030
Note receivable current	16,429	16,429
Total current assets	5,970,089	6,816,139
Property and equipment		
Furniture, fixtures and office equipment	317,444	288,472
Machinery and equipment	384,553	397,359
Leasehold improvements	159,674	133,522
Total property and equipment	861,671	819,353
Less: accumulated depreciation & amortization	(552,815)	(379,680)
Net property and equipment	308,856	439,673
Note receivable long term	58,869	71,190
Goodwill	2,100,000	2,100,000
Patents, licenses and other intangible assets (net of accumulated amortization of $302,835 at September 30, 2003 and $299,985 at December 31, 2002)	56,928	59,778
Total assets	$ 8,494,742	$ 9,486,780

See notes to condensed consolidated financial statements.

MFIC CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS (continued)

		September 30, 2003 (unaudited)		December 31, 2002
LIABILITIES AND STOCKHOLDERS EQUITY				
Current Liabilities:				
Line of credit	$	2,236,331	$	2,681,987
Accounts payable and accrued expenses		1,493,995		1,899,113
Accrued interest related party		5,035		14,980
Accrued compensation		86,540		158,119
Customer advances		272,984		320,224
Current portion of long term debt related party		75,000		75,000
Current portion of note payable		82,486		95,004
Total current liabilities		4,252,371		5,244,427
Term note net of current portion		0		58,735
Long term debt net of current portion related party		25,000		81,250
Stockholders equity				
Common stock, par value $.01 per share, 20,000,000 shares authorized; 7,749,281 and 7,705,064 shares issued and outstanding at September 30, 2003 and December 31, 2002, respectively		77,493		77,051
Additional paid-in capital		12,959,116		12,945,520
Accumulated deficit		(8,131,537)		(8,232,502)
Less: Treasury stock, at cost, 260,446 shares		(687,701)		(687,701)
Total stockholders equity		4,217,371		4,102,368
Total liabilities and stockholders equity	$	8,494,742	$	9,486,780

See notes to condensed consolidated financial statements.

MFIC CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three months ended September 30, 2003 (unaudited)	Three months ended September 30, 2002 (unaudited)	Nine months ended September 30, 2003 (unaudited)	Nine months ended September 30, 2002 (unaudited)
Revenues	$ 2,617,887	$ 3,599,687	$ 10,560,353	$ 10,825,761
Cost of goods sold	1,469,682	2,029,248	5,740,834	6,033,361
Gross profit	1,148,205	1,570,439	4,819,519	4,792,400
Operating expenses:				
Selling	671,971	733,427	2,256,731	2,236,210
Research and development	293,361	202,465	785,332	644,921
General and administrative	501,686	575,398	1,593,867	1,607,082
Total operating expenses	1,467,018	1,511,290	4,635,930	4,488,213
(Loss) income from operations	(318,813)	59,149	183,589	304,187
Interest income	2,465	2,285	6,965	5,219
Interest expense	(26,998)	(47,748)	(89,589)	(140,042)
Net (loss) income before cumulative effect of accounting change	(343,346)	13,686	100,965	169,364
Cumulative effect of accounting change				(2,661,409)
Net (loss) income	$ (343,346)	$ 13,686	$ 100,965	$ (2,492,045)
Net (loss) income per share prior to cumulative effect of accounting change:				
Basic and diluted	$ (0.05)	$ 0.00	$ 0.01	$ 0.02
Cumulative effect of accounting change	$	$	$	$ (0.36)
Net (loss) income per share after cumulative effect of accounting change:				
Basic and diluted	$ (0.05)	$ 0.00	$ 0.01	$ (0.34)
Weighted average number of common and common equivalent shares outstanding:				
Basic	7,488,835	7,444,618	7,468,203	7,420,575
Diluted	7,488,835	7,463,171	7,661,476	7,420,575

See notes to condensed consolidated financial statements.

MFIC CORPORATION

<u>CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS</u>

		Nine months ended September 30, 2003 (unaudited)		Nine months ended September 30, 2002 (unaudited)
Cash flows from operating activities:				
Net income (loss)	$	100,965	$	(2,492,045)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Change in accounting principle: Impairment of goodwill				2,661,409
Depreciation and amortization		196,449		228,525
Gain on sale of fixed assets		(23,500)		(32,279)
Bad debt expense		9,378		16,888
Changes in assets and liabilities:				
Trade and other receivables		1,038,045		516,620
Inventories		(258,006)		(137,813)
Prepaid expenses		41,918		(25,702)
Other current assets		33,839		45,219
Current liabilities		(533,882)		(349,504)
Net cash provided by operating activities:		605,206		431,318
Cash flows from investing activities:				
Proceeds from sales of property and equipment		23,500		75,125
Purchase of property and equipment		(62,782)		(132,067)
Net cash used in investing activities		(39,282)		(56,942)
Cash flows from financing activities:				
Principal payment of subordinated debt related party		(56,250)		(62,500)
Payment on line of credit		(445,656)		(190,582)
Principal payments on term note		(71,253)		(71,253)
Proceeds from note receivable		12,321		
Proceeds from exercise of employee stock options		2,325		6,006
Proceeds from issuance of restricted common stock				11,668
Proceeds from issuance of common stock under employee stock purchase plan		11,713		11,581
Net cash used in financing activities		(546,800)		(295,080)
Net increase in cash and cash equivalents		19,124		79,296
Cash and cash equivalents at beginning of period		84,956		87,386
Cash and cash equivalents at end of period	$	104,080	$	166,682

See notes to condensed consolidated financial statements.

MFIC CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. ORGANIZATION, BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

MFIC Corporation (MFIC or the Company), through its wholly-owned subsidiary, Microfluidics Corporation (Microfluidics Division), as well as its operating division, Morehouse-COWLES, specialize in producing and marketing a broad line of proprietary fluid materials processing systems used for a variety of grinding, mixing, milling, and blending applications across a variety of industries and for use in numerous applications within those industries. Microfluidizer® materials processor systems are produced at the Microfluidics Division, while dispersers, dissolvers, colloid mills, horizontal media and vertical media mills are produced at the Morehouse-COWLES Division. The Morehouse-COWLES Division also sells and distributes grinding media. The Company also maintains a wholly-owned subsidiary, MediControl Corporation (MediControl), which has been inactive since 1996.

The consolidated financial statements of the Company include the accounts of the Company and its wholly owned subsidiaries, Microfluidics and MediControl. All significant intercompany transactions and balances have been eliminated in consolidation.

BASIS OF PRESENTATION

The condensed consolidated financial statements included herein have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. The Company believes, however, that the disclosures are adequate to make the information presented not misleading. It is suggested that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s latest annual report on Form 10-K.

The condensed consolidated financial statements, in the opinion of management, include all adjustments necessary to present fairly the Company s financial position and the results of operations. These results are not necessarily indicative of the results to be expected for the entire year.

SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies followed by the Company and its subsidiaries in preparing its consolidated financial statements are set forth in Note 1 to the consolidated financial statements included in its Form 10-K for the year ended December 31, 2002. The Company has made no changes to these policies during this quarter.

2. INVENTORIES

The components of inventories on the following dates were:

	September 30, 2003	December 31, 2002
Raw Material	$ 2,577,887	$ 2,507,487
Work in Progress	523,184	417,434
Finished Goods	1,055,033	973,177
Total	$ 4,156,104	$ 3,898,098

3. EARNINGS (LOSS) PER SHARE

Basic and diluted net earnings per share is presented in conformity with Statement of Financial Accounting Standards (SFAS) No. 128, *Earnings per Share,* for all periods presented. In accordance with SFAS No. 128, basic net income per common share was determined by dividing net income applicable to common stockholders by the weighted average number of common shares outstanding during the period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock, unless the effects of dilution would be anti-dilutive.

	Three months ended		Nine months ended	
	September 30, 2003	September 30, 2002	September 30, 2003	September 30, 2002
Shares for computation of basic net income per share	7,488,835	7,444,618	7,468,203	7,420,575
Effect of dilutive stock options and warrants		18,553	193,273	
Shares for computation of diluted net income per share	7,488,835	7,463,171	7,661,476	7,420,575

4. LINE OF CREDIT

At December 31, 2002, the Company was not in compliance with certain covenants of its Revolving Line of Credit Agreement (the Agreement). The Company received a waiver of these violations for the year ended December 31, 2002. On February 19, 2003, the Company and PNC Bank entered into a third amendment to the original Agreement extending the credit facility for an additional year until February 28, 2004, with one change to the revised covenants agreed upon under the second amendment to the Agreement (the Amended Agreement) of March 29, 2002, regarding Restrictions on Indebtedness. The Company was in compliance with the covenants on September 30, 2003.

Due to the subjective acceleration clause, and the lock-box arrangement, the Revolving Credit Line is classified as a current liability in the consolidated balance sheet. At September 30, 2003, 8

the outstanding balance on the Revolving Credit Line was $2,236,331, having an interest rate of 4.50%. The balance outstanding on the term loan was $82,486, at an interest rate of 4.75%.

5. STOCK BASED COMPENSATION

The Company applies Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its stock option plans. During the first quarter of fiscal 2003, the Company adopted the disclosure provisions of SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure.* The following table illustrates the effect on net earnings and earnings per share had the Company adopted the fair value based method of accounting for stock-based employee compensation for all periods presented.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	**2002**	**2003**	**2002**
Net (loss) earnings, as reported	$ (343,346)	$ 13,686	$ 100,965	$ (2,492,045)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	5,716	84,774	10,724	255,133
Pro forma (loss) net earnings	$ (349,062)	$ (71,088)	$ 90,241	$ (2,747,178)
Earnings per share:				
Basic and diluted as reported	$ (0.05)	$ 0.01	$ 0.01	$ (0.34)
Basic and diluted pro forma	$ (0.05)	$ 0.00	$ 0.01	$ (0.37)

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

1. RESULTS OF OPERATIONS

Total Company revenues for the quarter ended September 30, 2003 were $2,617,887, as compared to revenues of $3,599,687 in the corresponding period last year, representing a decrease of $981,800, or 27%. For the nine month period ended September 30, 2003, revenues decreased $265,408, or 2%, to $10,560,353 from $10,825,761 for the first nine months of 2002. The decrease in revenue for the three months ended September 30, 2003 is due to a decrease in sales of machines of approximately $632,000, and a decrease in the sale of spare parts of approximately $350,000. The decrease in revenue for the nine month period ended September 30, 2002 is due to a decrease in the sale of machines of approximately $314,000, offset by an increase in the sales of spare parts of approximately $48,000.

Cost of goods sold for the three months ended September 30, 2003 was $1,469,682, or 56% of revenue, compared to $2,029,248, or 56% of revenue, for the same period last year. For the nine month period ended September 30, 2003, cost of goods sold was $5,740,834, or 54% of revenue, compared to $6,033,361 or 56% of revenue, for the comparable period in 2002. The decrease in cost of goods sold in absolute dollars for both the three months ended September 30, 2003, and the nine months ended September 30, 2003, reflects the decreases in sales generated by the Company.

The Company s major product lines have different profit margins, as well as multiple profit margins within each product line. In the course of the periods compared, there may be significant changes in the cost of revenues as a percentage of revenue depending on the mix of product sold.

Total operating expenses for the three months ended September 30, 2003 were $1,467,018 or 56% of revenue, as compared to $1,511,290 or 42% of revenue for the same period last year, which is a decrease of $44,272 or 3%. Operating expenses for the nine months ended September 30, 2003 were $4,635,390 or 44% of revenue, as compared to $4,488,213 or 41% of revenue, for the same period last year, an increase of $147,717 or 3%.

Research and development expenses for the three months ended September 30, 2003 were $293,361 compared to $202,465 for the three months ended September 30, 2002, an increase of $90,896 or 45%. The increase in research and development expenses was primarily due to the increase in payroll costs of approximately $49,000, and an increase in research costs of approximately $32,000.

Research and development expenses for the nine months ended September 30, 2003 were $785,332 compared to $644,921 for the nine months ended September 30, 2002, an increase of $140,411 or 22%. The increase in research and development expenses was primarily due to an increase in headcount related payroll costs of approximately $75,000 and an increase in research costs of approximately $81,000.

Selling expenses for the three months ended September 30, 2003 decreased $61,456 or 8%, compared to the three months ended September 30, 2002, from $733,427 to $671,971. The

principal decreases in selling expenses were due to a reduction in commissions of approximately $114,000, offset by an increase in payroll costs of approximately $71,000.

Selling expenses for the nine months ended September 30, 2003 increased approximately $21,000 or 1% compared to the nine months ended September 30, 2002, from $2,236,210 to $2,256,731. The increases were due principally to an increase in payroll costs of approximately $31,000, partially offset by a decrease in commission expenses of approximately $11,000.

For the three months ended September 30, 2003, general and administrative expenses decreased by approximately $74,000 or 13%, from $575,398 to $501,686. The decrease in general and administrative expenses is principally due to a decrease in payroll costs of approximately $51,000, and a decrease in corporate expenses of approximately $40,000, partially offset by an increase in overhead costs of approximately $15,000.

For the nine months ended September 30, 2003, general and administrative expenses decreased by approximately $13,000 or 1%, from $1,607,082 to $1,593,867. The decrease in general and administrative expenses is principally due to a decrease in corporate expenses of approximately $37,000, a decrease in payroll costs of approximately $24,000, a decrease in professional fees of approximately $42,000, partially offset by an increase in overhead costs of approximately $62,000, and an increase in recruiting expenses of approximately $18,000.

Interest expense for the three months ended September 30, 2003 decreased approximately $21,000 or 43%, to $26,998 compared to $47,748 for the three months ended September 30, 2002. The overall decrease is due primarily to a reduction in the interest rate paid.

Interest expense for the nine months ended September 30, 2003 decreased approximately $50,000, or 36%, to $89,589, from $140,042 for the nine months ended September 30, 2002. The decrease is due principally to a reduction of the interest rate paid.

2. LIQUIDITY AND CAPITAL RESOURCES

The Company generated cash of $605,206 and $431,318 from operations for the nine months ended September 30, 2003 and 2002, respectively. For the nine months ended September 30, 2003, the Company s principal operating cash requirements were to fund its increase in inventory and decrease of current liabilities, offset by a decrease in trade and other receivables, prepaid expenses, other current assets, and net income from operations. For the nine months ended September 30, 2002, the Company s principal operating cash requirements were to fund its increase in inventories, prepaid expenses, decrease in current liabilities, and a net loss from operations, offset by a decrease in trade and other receivables.

The Company used cash of $39,282 and $56,942 in investing activities for the nine months ended September 30, 2003 and 2002, respectively. Net cash used for investing activities for both the nine months ended September 30, 2003 and 2002, respectively included the purchase of capital equipment, offset by the proceeds from sales of fixed assets. As of September 30, 2003, the Company had no material commitments for capital expenditures.

The Company used cash of $546,800 and $295,080 in financing activities for the nine months ended September 30, 2003 and 2002, respectively. For the nine months ended September 30, 2003, the Company used cash for payments on the line of credit, the term note and subordinated debt, offset by proceeds from the issuance of common stock. For the nine months ended September 30, 2002, the Company used cash for payments on the line of credit, the term note, and subordinated debt, partially offset by proceeds from the issuance of common stock.

As of September 30, 2003, the Company had $104,080 in cash and cash equivalents, an increase of $19,124 from the December 31, 2002 balance of $84,956.

As of September 30, 2003, the Company maintains a revolving credit and term loan agreement (the Credit Facility) with PNC Bank, N.A., providing the Company with a $4,475,000 three-year revolving credit and term loan facility. On February 19, 2003, the Company and PNC Bank, N.A. entered into a third amendment to the original agreement extending the credit facility for an additional year until February 28, 2004, with one change to the revised covenants agreed upon under the second amendment to the agreement of March 29, 2002, regarding Restrictions on Indebtedness. The Company was in compliance with the covenants as of September 30, 2003.

Assuming that there is no significant change in the Company s business, the Company believes that cash flows from operations, together with the Credit Facility, and the existing cash balances, will be sufficient to meet its working capital requirements for at least the next twelve months.

The Company s ability to continue planned operations is dependent upon access to financing under its Credit Facility, which is potentially impacted by the Company s ability to achieve future compliance with the financial covenants. Given the terms of the financial covenants and historical results, it is at least reasonably possible that the Company will be in violation of the financial covenants under its Credit Facility in the future. Management of the Company has executed plans to attempt to ensure attainment of profitability, including the concentration of manufacturing operations in an effort to improve costs and marketing leverage; however, there can be no assurance that the Company will be successful in implementing these plans, or maintaining profitability after implementation. Likewise, there can be no assurance that, if the

Company is not in compliance with loan covenants of its Credit Facility on a future date, that the Company will be able to obtain a waiver of such non-compliance from PNC Bank, N.A. Assuming that there is no significant change in the Company s business, the Company believes that cash flows from operations, together with the Credit Facility, and the existing cash balances, will be sufficient to meet its working capital requirements for at least the next twelve months.

3. FORWARD-LOOKING STATEMENTS

This report may contain forward-looking statements that are subject to certain risks and uncertainties including statements relating to the Company s plan to achieve revenue growth, to maintain and/or increase operating profitability, and to attain net income profitability. Such statements are based on the Company s current expectations and are subject to a number of factors and uncertainties that could cause actual results achieved by the Company to differ materially from those described in the forward-looking statements. The Company cautions investors that there can be no assurance that the actual results or business conditions will not differ materially from those projected or suggested in such forward-looking statements as a result of various factors, including but not limited to, the following risks and uncertainties: (i) whether the performance advantages of the Company s Microfluidizer® or Zinger® materials processing equipment will be realized commercially or that a commercial market for the equipment will continue to develop, and (ii) whether the Company will have access to sufficient working capital through continued and improving cash flow from sales and ongoing borrowing availability, the latter being subject to the Company s ability to maintain compliance with the covenants and terms of the Company s loan agreement with its senior lender.

ITEM 3. QUANTITIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company s exposure to market risk is principally confined to its financial instruments. The Company s financial instruments are generally not subjected to changes in market value as a result of changes in interest rates due to the short maturities of the instruments. The Company s fixed rate debt is not exposed to cash flow or interest rate changes but is exposed to fair market value changes in the event of refinancing this fixed rate debt. The Company does not have significant exposure to fluctuations in foreign exchange rates.

The Company had approximately $2,319,000 of variable rate borrowings outstanding under its revolving credit agreement at September 30, 2003. A hypothetical 10% adverse change in interest rates for this variable rate debt would have had an approximate $12,000 negative effect on the Company s earnings and cash flows on an annual basis.

ITEM 4. DISCLOSURE CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer and the Company s Principal Financial and Accounting Officer, of the effectiveness of the design and operation of the Company s disclosure controls and procedures, as defined in Exchange Act Rule 15d-15(e). Based upon that evaluation, the Company s Chief Executive Officer and the Company s Principal Financial and Accounting Officer concluded that the Company s disclosure controls and procedures are effective in enabling the Company to record, process, summarize and report information required to be included in the Company s periodic SEC filings within the required time period. There have been no changes in the Company s internal control over financial reporting that occurred during the Company s last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

PART II- OTHER INFORMATION

ITEM 6. **EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits

Number	**Description**
31.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2003
31.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2003
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2003
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2003

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.

MFIC CORPORATION

/s/ Irwin J. Gruverman
Irwin J. Gruverman
Chief Executive Officer
(Principal Executive Officer)

Date: November 10, 2003