MERGE HEALTHCARE INC
Form 10-Q
May 07, 2010

UNITED STATES
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, 2010

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 0–29486

MERGE HEALTHCARE INCORPORATED
(Exact name of Registrant as specified in its charter)

Delaware	39–1600938
(State or other jurisdiction of incorporation or organization)	(I. R. S. Employer Identification No.)

6737 West Washington Street, Suite 2250, Milwaukee, Wisconsin 53214–5650
(Address of principal executive offices, including zip code)

(Registrant’s telephone number, including area code) (414) 977–4000

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 o

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 (§232.405 of this chapter) 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, or a non-accelerated filer, or a smaller reporting company. See the definitions of “accelerated filers”, “large accelerated filer” and “smaller reporting company” in Rule 12b–2 of the Exchange Act.

Large accelerated filer o	Accelerated filer x

Non-accelerated filer ¨	Smaller reporting company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b–2 of the Act).

Yes o No x

The number of shares outstanding of the Registrant's common stock, par value $0.01 per share, as of May 7, 2010: 82,758,904

INDEX

		Page
	PART I – FINANCIAL INFORMATION	
Item 1.	Condensed Consolidated Financial Statements	1
	Condensed Consolidated Balance Sheets (Unaudited)	1
	Condensed Consolidated Statements of Operations (Unaudited)	2
	Condensed Consolidated Statements of Cash Flows (Unaudited)	3
	Condensed Consolidated Statement of Shareholders' Equity (Unaudited)	4
	Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited)	5
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	23
Item 4.	Controls and Procedures	23
	PART II – OTHER INFORMATION	
Item 1.	Legal Proceedings	24
Item 1A.	Risk Factors	24
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	24
Item 3.	Defaults Upon Senior Securities	24
Item 5.	Other Information	24
Item 6.	Exhibits	24
	Exhibit 31.1 Section 302 Certification of Principal Executive Officer	27
	Exhibit 31.2 Section 302 Certification of Principal Financial Officer	28
	Exhibit 32 Section 906 Certification of Principal Executive and Financial Officers	29

Index

PART I – FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands, except for share data)

ASSETS	March 31, 2010	December 31, 2009
Current assets:		
Cash and cash equivalents, including restricted cash of $517 and $559 at March 31, 2010 and December 31, 2009, respectively	$ 15,837	$ 19,621
Accounts receivable, net of allowance for doubtful accounts and sales returns of $1,333 and $1,287 at March 31, 2010 and December 31, 2009, respectively	20,926	17,219
Inventory	312	280
Prepaid expenses	1,968	1,896
Deferred income taxes	142	142
Preferred stock deposits in escrow	25,700	-
Other current assets	3,638	3,590
Total current assets	68,523	42,748
Property and equipment:		
Computer equipment	5,995	8,542
Office equipment	1,996	2,347
Leasehold improvements	1,741	1,715
	9,732	12,604
Less accumulated depreciation	5,902	8,727
Net property and equipment	3,830	3,877
Purchased and developed software, net of accumulated amortization of $16,479 and $15,488 at March 31, 2010 and December 31, 2009, respectively	12,227	12,621
Customer relationships and trade names, net of accumulated amortization of $2,825 and $2,411 at March 31, 2010 and December 31, 2009, respectively	6,500	6,715
Goodwill	30,784	28,749
Deferred income taxes	4,689	4,689
Investments	510	523
Other assets	3,021	327
Total assets	$ 130,084	$ 100,249
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 5,137	$ 4,444
Accrued wages	1,880	1,950
Restructuring accrual	470	879
Current portion of capital lease obligations	121	130
Preferred stock deposits	30,000	-
Other accrued liabilities	2,593	1,535
Deferred revenue	16,804	15,579
Total current liabilities	57,005	24,517

Capital lease obligations, net of current portion	27	75
Deferred income taxes	68	68
Deferred revenue	1,365	1,193
Income taxes payable	5,476	5,461
Other	786	798
Total liabilities	64,727	32,112
Shareholders' equity:		
Series B Preferred Stock, $0.01 par value: 1,000,000 shares authorized; zero shares issued and outstanding at March 31, 2010 and December 31, 2009	-	-
Series 3 Special Voting Preferred Stock, no par value: one share authorized; zero shares issued and outstanding at March 31, 2010 and December 31, 2009	-	-
Common stock, $0.01 par value: 100,000,000 shares authorized: 74,801,731 and 74,791,753 shares shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively	748	748
Common stock subscribed, 15,509 and 9,978 shares at March 31, 2010 and December 31, 2009, respectively	31	32
Additional paid-in capital	524,500	524,114
Accumulated deficit	(461,508)	(458,356)
Accumulated other comprehensive income	1,586	1,599
Total shareholders' equity	65,357	68,137
Total liabilities and shareholders' equity	$ 130,084	$ 100,249

See accompanying notes to unaudited condensed consolidated financial statements.

Index

MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)
(in thousands, except for share and per share data)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Net sales:		
Software and other	$9,365	$8,684
Services and maintenance	10,605	6,625
Total net sales	19,970	15,309
Cost of sales:		
Software and other	704	1,230
Services and maintenance	4,494	2,150
Depreciation and amortization	1,218	650
Total cost of sales	6,416	4,030
Gross margin	13,554	11,279
Operating costs and expenses:		
Sales and marketing	2,819	1,672
Product research and development	3,256	2,271
General and administrative	3,851	3,252
Acquisition-related expenses	5,938	-
Depreciation and amortization	840	548
Total operating costs and expenses	16,704	7,743
Operating income (loss)	(3,150)	3,536
Other income (expense):		
Interest expense	(5)	(761)
Interest income	15	8
Other, net	36	81
Total other income (expense)	46	(672)
Income (loss) before income taxes	(3,104)	2,864
Income tax expense	48	22
Net income (loss)	$(3,152)	$2,842
Net income (loss) per share - basic	$(0.04)	$0.05
Weighted average number of common shares outstanding - basic	74,801,177	56,304,568
Net income (loss) per share - diluted	$(0.04)	$0.05
Weighted average number of common shares outstanding - diluted	74,801,177	57,189,532

See accompanying notes to unaudited condensed consolidated financial statements.

Index

MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(in thousands)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Cash flows from operating activities:		
Net income (loss)	$(3,152)	$2,842
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,058	1,198
Share-based compensation	354	519
Change in contingent consideration for acquisitions	165	-
Amortization of note payable issuance costs & discount	-	274
Provision for doubtful accounts receivable and sales returns, net of recoveries	55	234
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(3,574)	(842)
Inventory	(20)	436
Prepaid expenses	(72)	53
Accounts payable	694	(626)
Accrued wages	(70)	169
Restructuring accrual	(408)	(500)
Deferred revenue	849	(2,004)
Other accrued liabilities	(324)	(333)
Other	(1,157)	463
Net cash provided by (used in) operating activities	(4,602)	1,883
Cash flows from investing activities:		
Cash paid for acquisitions, net of cash acquired	(1,350)	-
Purchases of property, equipment, and leasehold improvements	(555)	(67)
Change in restricted cash	42	258
Preferred stock deposits in escrow	(25,700)	-
Net cash provided by (used in) investing activities	(27,563)	191
Cash flows from financing activities:		
Note and stock issuance costs paid	(1,551)	-
Proceeds from exercise of stock options and employee stock purchase plan	31	26
Principal payments on capital leases	(57)	-
Preferred stock deposits	30,000	-
Net cash provided by financing activities	28,423	26
Net increase (decrease) in cash and cash equivalents	(3,742)	2,100
Cash and cash equivalents (net of restricted cash), beginning of period (1)	19,062	17,227
Cash and cash equivalents (net of restricted cash), end of period (2)	$15,320	$19,327
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	$5	$488
Cash paid for income taxes, net of refunds	$56	$(207)

(1) Net of restricted cash of $559 and $621 at December 31, 2009 and 2008, respectively.

(2) Net of restricted cash of $517 and $363 at March 31, 2010 and 2009, respectively.

See accompanying notes to unaudited condensed consolidated financial statements.

Index

MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
(Unaudited)
(in thousands, except for share and per share data)

	Preferred Stock		Common Stock						Accumulated	
	Shares Issued	Issued Amount	Shares Subscribed	Subscribed Amount	Shares Issued	Issued Amount	Additional Paid–in Capital	Accumulated Deficit	Other Comprehensive Income	Total Shareholders' Equity
Balance at December 31, 2009	-	$ -	9,978	$ 32	74,791,753	$ 748	$ 524,114	$ (458,356)	$ 1,599	$ 68,137
Stock issued under ESPP	-	-	5,531	(1)	9,978	-	32	-	-	31
Share-based compensation expense	-	-	-	-	-	-	354	-	-	354
Net loss	-	-	-	-	-	-	-	(3,152)	-	(3,152)
Other comprehensive loss	-	-	-	-	-	-	-	-	(13)	(13)
Balance at March 31, 2010	-	$ -	15,509	$ 31	74,801,731	$ 748	$ 524,500	$ (461,508)	$ 1,586	$ 65,357

See accompanying notes to unaudited condensed consolidated financial statements.

Index

MERGE HEALTHCARE INCORPORATED AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Unaudited)
(in thousands)

	Three Months Ended March 31,	
	2010	2009
Net income (loss)	$(3,152)	$2,842
Unrealized loss on marketable security	(13)	(163)
Comprehensive net income (loss)	$(3,165)	$2,679

See accompanying notes to unaudited condensed consolidated financial statements.

Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements

(Unaudited and in thousands, except for share and per share data)

(1) Basis of Presentation and Significant Accounting Policies

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) for reporting on Form 10-Q. Accordingly, certain information and notes required by United States of America generally accepted accounting principles (GAAP) for annual financial statements are not included herein. These interim statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2009 of Merge Healthcare Incorporated, a Delaware corporation, and its subsidiaries and affiliates (which we sometimes refer to collectively as “Merge,” “we,” “us” or “our”).

Principles of Consolidation

Our unaudited condensed consolidated financial statements reflect all adjustments, which are, in the opinion of management, necessary for a fair presentation of our financial position and results of operations. Such adjustments are of a normal recurring nature, unless otherwise noted. The results of operations for the quarterly period ended March 31, 2010 are not necessarily indicative of the results to be expected for any future period.

Our unaudited condensed consolidated financial statements are prepared in accordance with GAAP. These accounting principles require us to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We believe that the estimates, judgments and assumptions are reasonable, based on information available at the time they are made. Actual results could differ materially from those estimates.

(2) Acquisitions

Insignificant Acquisition

We completed one insignificant acquisition of assets in the first quarter of 2010. Based on our preliminary purchase price allocation, estimated total consideration was $2,674, including $1,350 in cash, $150 held in escrow and contingent consideration of $1,174.

Acquisition of AMICAS, Inc.

On April 28, 2010, we completed our acquisition of AMICAS, Inc. (AMICAS) through a tender offer for the 37,009,990 outstanding shares of common stock of AMICAS at $6.05 per share in cash. Following the tender offer, we purchased the remaining shares pursuant to a merger of a subsidiary of Merge with and into AMICAS. Total transaction consideration was approximately $223,910. In addition, shortly before the completion of the acquisition, AMICAS paid cash to holders of vested, in-the-money stock options for the difference between $6.05 per share and the exercise price of such options. The holders of shares of restricted stock were paid $6.05 per share in cash. The total consideration paid to option and restricted stock holders was approximately $22,906.

We financed the transaction with $200,000 of senior secured notes (Notes), cash already available at the two companies and proceeds of $41,750 from the issuance of preferred and common stock. The Notes were issued at 97.266% of the principal amount, are due in 2015, bear interest at 11.75% of principal (payable on May 1st and November 1st of each year) and were offered in a private placement pursuant to Rule 144A and Regulation S under the Securities Act of 1933, as amended. In connection with the Notes, we incurred issuance costs of $2,378 (which are recorded in other assets on the condensed consolidated balance sheet as of March 31, 2010) and will incur additional costs in the second quarter of 2010. These issuance costs will be recorded as a long-term asset and amortized over the life of the Notes.

We issued 41,750 shares of preferred stock and 7,515,000 shares of common stock for the $41,750 of proceeds received. As of March 31, 2010, we had received and placed $30,000 of the preferred stock proceeds in escrow pursuant to the Merger Agreement with AMICAS and were required to release $4,300 of the escrow to pay one-half of the break-up fees due to a former potential acquirer of AMICAS. In connection with the preferred and common stock offering, we incurred issuance costs of $142 (which are recorded in other assets in our condensed consolidated balance sheet as of March 31, 2010) and will incur additional costs in the second quarter of 2010. These issuance costs will be recorded as a reduction of additional paid-in capital in our condensed consolidated balance sheet upon issuance of the preferred and common stock in April 2010. Please see Note 6 for further information regarding the preferred stock and common stock issuance.

Index

Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

(Unaudited and in thousands, except for share and per share data)

In addition, we incurred $5,938 of costs related to our acquisitions which are recorded in our statement of operations in the quarter ended March 31, 2010. We expect to incur additional costs related to acquisitions, and will record such costs in the period the services are provided.

(3) Goodwill and Other Intangible Assets

Goodwill

The changes in carrying amount of goodwill by segment (as further discussed in Note 12) for the three months ended March 31, 2010, are as follows:

	Indirect	Direct	Total
Balance at December 31, 2009	13,245	15,504	28,749
Goodwill due to insignificant acquisitions	-	2,035	2,035
Balance at March 31, 2010	$ 13,245	$ 17,539	$ 30,784

Other Intangible Assets

Other than capitalized software development costs, our intangible assets subject to amortization are summarized as of March 31, 2010 as follows:

	Weighted Average Remaining Amortization Period (Years)	Gross Carrying Amount	Accumulated Amortization
Purchased software	4.1	$ 21,291	$ (10,212)
Customer relationships	7.2	8,755	(2,777)
Trade names	7.5	570	(48)
Total		$ 30,616	$ (13,037)

In the quarter ended March 31, 2010, we increased the gross carrying amount of purchased software and customer relationships by $597 and $199, respectively, related to insignificant asset purchases completed in 2010.

Estimated aggregate amortization expense for purchased software and customer relationships, which become fully amortized in 2019, for the remaining periods is as follows:

For the remaining 9 months of the year ended:	2010	$3,941

For the year ended December 31:	2011	3,573
	2012	2,372
	2013	2,349
	2014	2,198
	Thereafter	3,146

As of March 31, 2010, we had gross capitalized software development costs of $7,415 and accumulated amortization of $6,267. The weighted average remaining amortization period of capitalized software development costs was 3.4 years as of March 31, 2010. We did not capitalize any software development costs in the three months ended March 31, 2010 or 2009.

Index

Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

(Unaudited and in thousands, except for share and per share data)

Amortization expense for our intangible assets is set forth in the following table:

	Three Months Ended March 31,	
	2010	2009
Amortization of intangible assets:		
Purchased software	862	469
Capitalized software	129	181
Customer relationships and trade names	414	237
Total	$ 1,405	$ 887

Amortization expense for purchased software and capitalized software development costs are expensed within cost of sales on a ratable basis over the life of the related intangible asset. Customer relationships and trade names amortization expense is being expensed in the depreciation and amortization expense classification of operating costs and expenses over the life of the related intangible asset.

(4) Fair Value Measurement

We use a three-tier value hierarchy to prioritize the inputs used in measuring fair value of our financial assets and liabilities. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore, requiring us to develop our own assumptions.

We also consider additional information in estimating fair value when the volume and level of activity for the asset or liability have significantly decreased, or circumstances indicate a transaction is not suitable for fair value measurement. We disclose the required information about fair value of financial instruments in our interim financial statements as well as in our annual financial statements.

Non-Current Investments

At March 31, 2010, we held securities in a publicly traded entity valued at $97 and private companies valued at $413, which are classified as non-current assets. In determining fair value, we utilize techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. In calculating potential impairment losses for the private company securities, we evaluate the fair value of these investments by comparing them to certain public company metrics such as revenue multiples, independent transactions involving such securities, and inquiries and estimates made by us. The following tables set forth our non-current investments that are carried at fair value:

	Level 1	Level 2	Level 3	Balance at March 31, 2010

Investment in publicly traded equity security	$97	$-	$-	$ 97
Investments in equity securities of private companies	-	-	413	413
Total	$97	$-	$413	$ 510

	Level 1	Level 2	Level 3	Balance at December 31, 2009
Investment in publicly traded equity security	$110	$-	$-	$110
Investments in equity securities of private companies	-	-	413	413
Total	$110	$-	$413	$523

We performed the evaluation of our Level 3 investments in the quarterly period ended March 31, 2010, and concluded that there was no significant change in their fair value.

Index

Merge Healthcare Incorporated and Subsidiaries

Notes to Condensed Consolidated Financial Statements (continued)

(Unaudited and in thousands, except for share and per share data)

Unrealized gains or losses on our available-for-sale (publicly traded) security, as well as foreign currency translation adjustments, are components of accumulated other comprehensive income as set forth in the following table:

	Balance at March 31, 2010
Cumulative translation adjustment	